98th Congress
2d Session

HOUSE OF REPRESENTATIVES

Rept. 98-432
Part 2

TAX REFORM ACT OF 1984

SUPPLEMENTAL REPORT

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ON

H.R. 4170

[Including cost estimate of the Congressional Budget Office]

March 5, 1984.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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SUMMARY OF CONTENTS

Page

I. **Legislative Background** 1025
II. **Summary** 1029
III. **General Reasons** 1094
IV. **Revenue and Outlay Effects** 1099
V. **Explanation of Provisions** 1112
  TITLE I—TAX FREEZE; TAX REFORM'S GENERALLY 1112
  TITLE II—LIFE INSURANCE TAX PROVISIONS 1391
  TITLE III—REVISION OF PRIVATE FOUNDATION PROVISIONS 1463
  TITLE IV—TAX SIMPLIFICATION PROVISIONS 1488
  TITLE V—FRINGE BENEFIT PROVISIONS 1590
  TITLE VI—TECHNICAL CORRECTIONS PROVISIONS 1611
  TITLE VII—TAX-EXEMPT BOND PROVISIONS 1664
  TITLE VIII—MISCELLANEOUS REVENUE MATTERS 1702
  TITLE IX—SOCIAL SECURITY DISABILITY BENEFITS REFORM PROVISIONS 1758
  TITLE X—MEDICARE BUDGET RECONCILIATION AMENDMENTS 1791
  TITLE XI—TRADE ADJUSTMENT ASSISTANCE PROGRAMS... 1812
  TITLE XII—HIGHWAY VEHICLE USE AND DIESEL FUEL TAXES 1815
VI. **Budget Effects and Vote of the Committee** 1821
VII. **Other Matters To Be Discussed Under House Rules** 1830

CONTENTS

Page

I. Legislative Background 1025
II. Summary 1029
III. General Reasons for the Bill 1094
IV. Revenue and Outlay Effects of the Bill 1099
V. Explanation of Provisions 1112
- TITLE I—TAX FREEZE; TAX REFORMS GENERALLY 1112
  - A. Deferral of Certain Tax Reductions 1112
    - 1. Postpone Increase in Amount of Used Property Eligible for Investment Tax Credit 1112
    - 2. Postpone of Finance Lease Provisions 1113
    - 3. Postpone Increases in Amount of Property Eligible for Expensing 1119
    - 4. Employee Stock Ownership Plans 1120
    - 5. Limits on Contributions and Benefits under Qualified Pension Plans 1121
    - 6. Repeal of Net Interest Exclusion 1122
    - 7. Postpone Increase in Foreign Earned Income Exclusion 1123
    - 8. Defer Scheduled Reductions in Maximum Gift and Estate Tax Rates 1124
    - 9. Windfall Profit Tax on Newly Discovered Oil 1124
    - 10. Percentage Depletion for Secondary and Tertiary Production after 1983 1125
    - 11. Modification of Excise Tax Rates on Cigarettes and Distilled Spirits 1126
    - 12. Extension of Telephone Excise Tax 1129
  - B. Tax-Exempt Entity Leasing 1131
    - A. Present Law 1131
    - B. Reasons for Change 1138
    - C. Explanation of Provisions 1142
      - 1. Overview 1142
      - 2. Definition of tax-exempt entity 1142
      - 3. Tax-exempt use property 1143
      - 4. Depreciation 1148
      - 5. Investment tax credit 1151
      - 6. Property used under certain service contracts 1152
      - 7. Short-term lease exception 1161
      - 8. Lease term 1161
      - 9. Certain international operations 1162
      - 10. Definition of a related party 1162
      - 11. Exceptions 1163

Page
12. Regulations 1163
D. Effective Date 1163
E. Revenue Effect 1169
C—Treatment of Bonds and Other Debt Instruments 1170
1. Market Discount 1170
2. Discount on Short-Term Obligations 1174
3. Original Issue Discount on Tax-Exempt Bonds 1178
D—Tax Treatment of Corporations and Their Shareholders 1180
1. Debt-Financed Portfolio Stock 1180
2. Certain Dividends from Regulated Investment Companies 1183
3. Corporate Shareholder's Basis in Stock Reduced by Reason of Extraordinary Dividends 1184
4. Distributions of Appreciated Property by Corporations 1189
5. Capital Gains Distributions from RICs and REITs 1192
6. Denial of Deductions for Certain Expenses Incurred in Connection with Short Sales 1194
7. Warrants 1196
8. Accumulated Earnings Tax 1198
9. Exchange of Debt for Stock 1201
10. Distributions by a Corporation of Debt Obligations Having a Fair Market Value Less than Par 1203
11. Consolidated Returns 1205
E—Partnership Provisions 1208
1. Partnership Allocations with Respect to Contributed Property 1208
2. Retroactive Allocations 1211
3. Payments to Partners for Property or Certain Services 1216
4. Character of Gain or Loss on Disposition of Contributed Property 1222
5. Transfers of Partnership Interests by Corporations 1225
6. Abuses Involving Tiered Partnerships 1228
7. Exchanges of Like-Kind Property 1231
8. Allocation of Certain Liabilities to Limited Partners 1235
F—Trust Provisions 1237
1. Trust Distributions 1237
2. Taxation of Multiple Trusts 1239
G—Time Value of Money and Other Accounting Changes 1241
1. Timing and Measurement of Interest Inclusion and Deduction in Deferred Payment Transactions 1241
2. Premature Accruals 1252
3. Prepayments of Expenses 1258

Page

H. Provisions Relating to Tax Straddles 1262

I. Employee Benefit Provisions 1274

  1. Treatment of Funded Welfare Benefit Plans 1274
  2. Treatment of Unfunded Deferred Benefits . 1282
  3. Additional Requirements for Tax-Exempt Status of Certain Organizations 1285
  4. Amendments to Tax on Unrelated Business Income 1292
  5. Employer and Employee Benefit Association Treated as Related Persons Under Section 1239 1293
  6. Treatment of Certain Medical, etc., Benefits Under Section 415 1294
  7. Limitation on Accrual of Vacation Pay 1296
  8. Determination of Whether There Is a Collective Bargaining Agreement 1298
  9. Disqualification of Plan Where Substantially All Contributions Are Employee Contributions 1299
  10. Discrimination Standards Applicable to Cash or Deferred Arrangements 1301
  11. Revenue Effect of Employee Benefit Provisions 1303

J. Foreign Provisions 1304

  1. Income From Factoring Trade Receivables. 1304
  2. Taxation of Certain Transfers of Property Outside the United States 1307
  3. Gain From Sale or Exchange of Stock in Certain Foreign Corporations 1326
  4. Original Issue Discount and Coupon Stripping—Foreign Investors 1329
  5. Limitation on Cover Over (Payment) of Certain Federal Excise Taxes to Puerto Rico and the Virgin Islands 1334
  6. Source of Transportation Income 1337
  7. Use of Territories to Avoid U.S. Tax on Foreign Investors 1342
  8. Foreign Collapsible Corporations 1345
  9. Recharacterization of U.S. Income as Foreign Income 1346
  10. Recharacterization of Interest Income as Dividend Income 1349

K. Taxpayer Compliance Provisions 1351

  1. Promoter Lists of Syndicate Partnerships... 1351
  2. Reporting with Respect to Mortgage Interest Received in Trade or Business 1353
  3. Returns Relating to Foreclosures and Abandonments of Security 1355
  4. Increase in Penalty for Promoting Abusive Tax Shelters 1357
  5. Reporting of State and Local Income Tax Refunds Not Required with Respect to Non-Itemizers 1359

Page

6. Authorization to Disregard Appraisals of Persons Penalized for Aiding in Understatements of Tax Liability 1361
7. Provisions Relating to Individual Retirement Accounts 1362
8. Returns Relating to Exchanges of Partnership Interests Where Unrealized Receivables and Other Contributory Shares Are Involved 1364
9. Statements Required in Case of Certain Substitute Dividend Payments 1366
10. Revenue Effects of Compliance Provisions.. 1367

L. Miscellaneous Provisions 1368
1. Inclusion of Tax Benefit Items in Income ... 1368
2. Below-Market and Interest-Free Loans 1370
3. LIFO Conformity 1380
4. Collapsible Corporations 1382
5. Modification of Income Averaging 1385
6. Limitations on Depreciation and Investment Tax Credit for Luxury Automobiles 1387
7. Transfers of Depreciable Property Between Related Parties 1390

TITLE II—LIFE INSURANCE TAX PROVISIONS 1391

A. Present Law 1391
1. Pre-1959 taxation of life insurance companies 1391
2. The 1959 Act 1391
3. TEFRA changes 1394

B. Reasons for Change 1396

C. Explanation of Provisions 1400
1. Overview of the Bill 1400
2. Tax treatment of life insurance companies. 1402
a. Definition of a life insurance company.. 1402
b. Computation of life insurance company taxable income 1404
c. Policyholder surplus accounts 1410
d. Deductions with respect to reserves 1411
e. Policyholder dividends 1420
f. Operations loss deduction 1426
g. Accounting provisions 1427
h. Definition of company's share and policyholders' share 1430
i. Foreign tax credit 1431
j. Foreign life insurance companies' minimum surplus 1434
k. Contiguous country branches of U.S. life insurance companies 1436
l. Rules relating to capital gains and losses 1438
m. Technical and conforming amendments 1439
n. Effective date and transitional rules 1439
3. Taxation of life insurance products 1442
a. Definition of life insurance contract 1442

Page
b. Treatment of certain annuity contracts. 1450
c. Policyholder loans 1451
d. Group-term life insurance purchased for employees 1453
4. Nondeductible contributions to individual retirement plans 1456
5. Studies 1460
D. Revenue Estimates Relating to Title II of the Bill 1462
TITLE III—REVISION OF PRIVATE FOUNDATION PROVISIONS 1463
A. Limitations on Deduction for Contributions to Private Foundations 1463
B. Exemption for Certain Operating Foundations from Excise Tax on Investment Income and Expenditure Responsibility Rules 1465
C. Reduction in Section 4940 Excise Tax Where Charitable Payout Increases 1466
D. Amendments to Payout Requirements 1468
E. Abatement of First-Tier Excise Taxes in Certain Cases 1470
F. Amendment to Voter Registration Rules 1472
G. Definition of Family Member 1473
H. Public Disclosure and Accessibility of Information on Foundations to Grant Applicants 1474
I. Amendments to Excess Business Holding Rules 1476
J. Exemption for Certain Games of Chance 1481
K. Exception of Self-Dealing Rules for Certain Stock Transactions 1482
L. Termination of Status as Substantial Contributor 1483
M. Review of Treasury Regulations on Expenditure Responsibility 1484
N. Review of Treasury Regulations on Reliance on IRS Classifications 1486
O. Revenue Effect 1487
TITLE IV—TAX SIMPLIFICATION 1488
A. Estimated Income Tax 1488
B. Domestic Relations 1491
1. Treatment of Transfers of poverty between spouses or incident to divorce 1491
2. Alimony 1494
3. Dependency exemption 1498
4. Innocent spouse relieved of liability in certain cases 1501
5. Gift and estate tax treatment of certain property settlements 1504
C. Revision of At-Risk Rules 1506
D. Estate Tax Revisions 1516
1. Permanent rules for reforming governing instruments creating charitable remainder trusts and other charitable interests 1516
2. Alternate valuation date election 1521

Page
E. Foreign Tax Provisions 1523
  1. Resident aliens........ 1523
  2. Treatment of community property income of nonresident aliens........ 1532
  3. Foreign personal treatment on disposition ... 1534
  4. Ordinary income treatment on disposition of stock of certain foreign corporations........ 1538
  5. Coordination of subpart F with foreign personal holding company provisions........ 1541
  6. Stapled stock; stapled entities 1543
F. Miscellaneous Treasury Administrative Provisions 1548
  1. Simplification of certain reporting requirements........ 1548
  2. Removal of $1,000,000 limitation on working capital fund........ 1551
  3. Increase in limitation on revolving fund for redemption of real property 1552
  4. Removal of $1,000,000 limitation on authority to dispose of obligations 1553
  5. Secretary of the Treasury authorized to accept gifts and bequests........ 1554
  6. Extension of time for court review of jeopardy assessment where prompt service not made on United States 1555
  7. Extension of period to assess unpaid taxes. 1557
  8. Lien on assets of financial institutions for unpaid drafts 1558
  9. Disclosure of windfall profit tax to State tax agencies 1559
  10. Provisions relating to distilled spirits 1560
    a. Repeal of occupational tax on manufacturers of stills and condensers........ 1560
    b. Return of taxes on spirits used for food or medicinal purposes 1561
    c. Disclosure of alcohol fuel producers to administrators of State alcohol laws........ 1562
    d. Elimination of Government-supplied strip stamps for distilled spirits containers 1563
G. Tax Court Provisions........ 1566
  1. Small tax cases 1566
  2. Survivor annuities........ 1567
  3. Assignment of proceedings 1568
  4. Special trial judges........ 1569
  5. Publicity of Tax Court proceedings........ 1570
  6. Retirement age for Tax Court judges 1571
  7. Revenue effect........ 1572
H. Simplification of Income Tax Credits 1573
I. Miscellaneous Tax Provisions 1575
  1. Rollover of certain partial distributions from qualified plans 1575
  2. Treatment of certain related party transactions........ 1578

Page
3. Preferred stock eligible for small business corporation stock treatment 1581
4. Medical expense deduction for certain lodging 1583
5. Study of simplified gross income tax 1585
J. Repeal of Certain Obsolete Provisions (Deadwood) 1586
1. Termination of rules relating to qualified bond purchase plans and retirement bonds .. 1586
2. Repeal of section 1251 (relating to gains from disposition of certain property used in farming 1589
TITLE V. FRINGE BENEFITS PROVISIONS 1590
A. Present Law 1590
B. Reasons for Change 1591
C. Explanation of Provisions 1593
1. Overview 1593
2. No-additional-cost service 1593
3. Qualified employee discount 1597
4. Working condition fringe 1601
5. De minimis fringe 1603
6. Qualified tuition reductions 1604
7. Athletic facilities 1605
8. Nondiscrimination rules 1605
9. Other rules 1607
10. Cafeteria plans 1608
11. Treasury Regulations 1609
D. Effective Date 1610
E. Revenue Effect 1610
TITLE VI. TECHNICAL CORRECTIONS PROVISIONS 1611
A. Technical Corrections to the Tax Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 1611
1. Alternative minimum tax 1611
2. Casualty loss deduction 1612
3. Corporate minimum tax 1612
4. Investment tax credit basis adjustment 1613
5. Construction period interest and taxes 1613
6. Leasing 1613
7. Foreign taxation 1615
8. Partial liquidations 1616
9. Distributions of appreciated property in redemption of stock 1616
10. Treatment of certain stock purchases 1617
11. Treatment of certain holding companies 1624
12. Completed contract method of accounting .. 1627
13. Targeted jobs credit 1627
14. Limitations on benefits and contributions under qualified plans 1628
15. Loans to plan participants 1629
16. Repeal of special qualification requirements 1630

Page
17. Repeal of special limitations on deduction for self-employed individuals and subchapter S corporations 1631
18. Allowance of exclusion of death benefit for self-employed individuals 1632
19. Special rules for top-heavy plans 1633
20. Required distributions for qualified plans... 1634
21. Required distributions in case of individual retirement plans 1635
22. Existing personal service corporations liquidating in 1983 or 1984 1636
23. Nondiscriminatory coordination of defined contribution plans with OASDI 1637
24. Profit-sharing plan contributions on behalf of disabled employees 1637
25. Attorney's fees 1637
26. Withholding on pensions, annuities, and certain other deferred income 1638
27. Partnership audit 1638
28. Clerical amendments 1639
B. Technical Corrections to the Subchapter S Revision Act of 1982 1640
1. Corporate liquidations, etc 1640
2. Treatment of discharge of indebtedness 1640
3. Treatment of inactive subsidiaries 1641
4. Treatment of worthless debt 1641
5. Investment tax credit recapture 1641
6. Qualified subchapter S trusts 1642
7. Accounting treatment where election terminates 1642
8. Passive income rules for 1982 1643
9. Attribution 1643
10. Certain short taxable years 1643
11. Taxable years of existing S corporations 1644
12. Distributions during post-termination period 1644
13. Corporate preference items 1644
14. Accumulated adjustments account 1645
15. Clerical amendments 1645
C. Technical Corrections to Miscellaneous Provisions 1646
1. Tax preference for low-income housing 1646
2. Foreign currency contracts 1646
3. Effective date of corporation acquisition provision 1646
4. Coordination of certain amendments made by the Highway Revenue Act of 1982 and Public Law 97-473 1647
5. Campaign committees 1647
D. Technical Corrections to the Highway Revenue Act of 1982 1649
1. Application of retail truck and trailer excise tax to vehicles including used parts.... 1649

Page
2. Application of gasoline excise tax to gasohol 1649
3. Certain chain operators of retail gasoline stations treated as producers 1649
4. Floor stocks refunds for tax-reduced tires 1650
5. Collection of excise tax on noncommercial aviation gasoline 1650
6. Floor stocks refunds for retread tires 1651
7. Other technical and conforming changes 1651
E. Technical Corrections to the Social Security Amendments of 1983 and Related Legislation 1652
1. Foreign work test: Withholding from auxiliary on account of work performed by a retired worker 1652
2. FICA treatment of employer pickup of employee contributions under State and local retirement plans 1652
3. Social security coverage of Federal workers 1653
4. Basis for calculation of alternate annual cost-of-living adjustments 1654
5. Benefits of persons receiving pensions from noncovered employment 1654
6. Gender-based distinction concerning entitlement of divorced husbands 1655
7. Financing of noncontributing military wage credits 1655
8. Effective date for elimination of gender-based distinction concerning divorced husbands 1656
9. Effective date for treatment of certain deferred remuneration 1656
10. Codification of the Rowan decision 1657
11. Exclusion from coverage of foreign agricultural workers under the Agricultural Act of 1949 1659
12. Gender-based distinction concerning the penalty for fraud 1659
13. Treatment of social security benefits in computing credit for the elderly and disabled 1659
14. Peer review organizations 1660
15. Medicare prospective payment 1660
16. Normalizing credit of medicare taxes to the Hospital Insurance Trust Fund 1661
17. Effective dates relating to certain medicare changes 1661
18. Enrollment and premium penalty with respect to working aged provisions 1662
19. Miscellaneous corrections 1663
F. Effective Dates 1663
G. Revenue Effect 1663
TITLE VII. TAX-EXEMPT BOND PROVISIONS 1664
A. Mortgage Subsidy Bonds 1664

Page
1. Extension of authority to issue qualified mortgage bonds 1669
2. Mortgage credit certificates 1670
3. Limited equity cooperatives 1673
B. Private Activity Bonds 1675
1. Volume limitation on IDBs and student loan bonds 1685
2. Denial of tax exemption for obligations issued with a Federal guarantee 1689
3. Other limitations on the use of IDBs 1691
a. Restrictions on use of small issue IDBs where beneficiary has significant IDB use 1691
b. Restrictions on use of IDBs for purchase of land or existing facilities 1691
c. Denial of tax-exempt IDB financing for certain obligations 1693
d. Extension of Internal Revenue Code rules to certain obligations 1693
e. Restriction on cost recovery deductions for property financed with IDBs 1694
f. Application of small issue IDB limits to entire project 1694
g. Extension of substantial user rule to all partners 1695
h. Clarification that residential rental property may be in a mixed use structure 1695
i. Increase in amount of capital expenditures not taken into account where there is an Urban Development Action grant 1695
j. Obligations of public approval requirement in case of certain airport facilities 1696
k. Repeal of advance refunding for qualified public facilities 1696
4. Extension of mortgage subsidy bond arbitrage rules to IDBs and student loans 1696
C. Tax-Exempt Status of Obligations of Certain Educational Organizations 1700
TITLE VIII—MISCELLANEOUS REVENUE MATTERS 1702
A. Capital Gain Treatment for Portion of Gain on Sale of Condominium Units Converted From Existing Structures 1702
B. No Gain Recognized From Net Gifts Made Before March 31, 1981 1707
C. Disaster Loss Deduction Where Taxpayer Ordered To Demolish Area Because of Disaster 1709
D. Foreign Investment Companies 1713
E. Application of Cash or Deferred Arrangement Rules to Pre-ERISA Money Purchase Plan 1720
F. Continuation of Suspension of Effective Date for Certain NOL Carryover Rules 17222

Page

G. Extension of Special Tax Rules for the Payment-in-Kind Tax Program 1723
H. Effective Date for 1978 Revenue Act Rules on Taxation of Unemployment Compensation Benefits 1737
I. Tax Refunds Relating to Traveling Expenses Incurred in 1970–74 for Employment at North Dakota Anti-Ballistic Missile Site 1739
J. Nonimposition of Interest and Penalties on Tax Liability With Respect to Home Won as Prize and Designed for Handicapped Foster Child of the Taxpayer 1742
K. Amendments With Respect to the Tax Treatment of Regulated Investment Companies 1744
L. Federal Unemployment Tax Act Treatment of Tip Income 1748
M. Qualification of Certain Holding Company Stock for Installment Payment of Estate Tax 1750
N. Dollar Limits on Benefits Under Qualified Pension Plans for Airline Pilots 1753
O. Removal of Distilled Spirits for Use in Production of Certain Non-Beverage Wine Without Payment of Tax 1754
P. Investment Income From Subchapter S Corporations 1755
Q. Tax Treatment of Certain Nonprofit Dependent Care Organizations 1756

TITLE IX—SOCIAL SECURITY DISABILITY BENEFIT REFORM PROVISIONS 1758
- A. Purpose and Scope 1758
- B. Explanation of Provisions 1759
  - 1. Standard of disability 1759
    - a. Overview 1759
    - b. Standard of review for terminations of disability benefits 1762
    - c. Study concerning evaluation of pain 1766
    - d. Multiply impairments 1767
  - 2. Disability determination process 1768
    - a. Moratorium on mental impairment reviews 1768
    - b. Face-to-face hearings in State disability determination agencies 1769
    - c. Payment of benefits during appeal 1770
    - d. Qualifications of medical professionals 1771
    - e. Regulatory standards for consultative examinations 1772
  - 3. Miscellaneous provisions 1773
    - a. Uniform standards for disability determinations 1773
    - b. SSA compliance with certain Federal court decisions 1775
    - c. Payment from trust funds for costs of rehabilitation services 1779

Page
d. Advisory Council on Medical Aspects of Disability 1780
e. Qualifying experience for appointment of certain staff attorneys to administrative law judge positions 1781
4. SSI provisions 1781
a. Extension of the section 1619 program for the SSI disabled who perform substantial gainful activity despite severe medical impairment 1781
b. SSI disability program work evaluation and rehabilitation study 1785
c. SSI conforming amendments 1790
5. Effective date 1790
TITLE X—MEDICARE BUDGET RECONCILIATION AMENDMENTS 1791
A. Payment- and Coverage-Related Changes 1791
1. Payment for outpatient diagnostic laboratory tests 1791
2. Coverage of administration of hepatitis B vaccine 1792
3. Pacemaker reimbursement review and reform 1793
4. Payment for debridement of mycotic toenails 1795
5. Payment for costs of hospital-based mobile intensive care units 1795
6. Payments for physicians' furnished to hospital inpatients 1796
B. Miscellaneous Administrative Changes 1799
1. Presidential appointment of and pay level for the administrator of the Health Care Financing Administration 1799
2. Permitting limited provider representation on peer review organizations 1799
3. Access to home health services 1800
4. Repeal of special tuberculosis treatment requirements 1801
5. Indirect payment of supplementary medical insurance benefits 1801
6. Including podiatrists in definition of "physician" for outpatient physical therapy services and including podiatrists and dentists in definition of "physician" for outpatient ambulatory surgery 1801
7. Establishment by physical therapists of plans for physical therapy 1802
8. Access to records of subcontractors 1803
9. Medicare recovery against certain third parties 1803
10. Use of accrediting organizations for certain entities furnishing services 1804
11. Confidentiality of accreditation surveys 1804

Page
12. Thirty-day coverage for services furnished by a home health agency whose agreement has been terminated 1804
13. Termination of agreements with institutions and entities where owners or certain other individuals have been convicted of certain offenses 1805
14. Elimination of Health Insurance Benefits Advisory Council 1805
15. Open enrollment periods for health maintenance organizations and competitive medical plans 1806
16. Deadline for report on including payment for physicians' services to hospital inpatients in DRG payment amounts 1807
17. Flexible sanctions for noncompliance with requirements for end-stage renal disease facilities 1807
18. Removing costs of nurse anesthetists from DRG-based payments 1807
19. Determination of hospital area wage index 1809
20. Definition of bona fide emergency services for purposes of limitations on payment for hospital outpatient services 1810
21. Delay of effective date for single-rate for skilled nursing facilities 1811

TITLE XI—TRADE ADJUSTMENT ASSISTANCE PROGRAMS 1812
A. Limitation on Trade Readjustment Allowances 1812
B. Job Search and Relocation Allowances 1812
C. Assistance to Industry 1813

TITLE XII—HIGHWAY VEHICLE USE AND DIESEL FUEL TAXES 1815

VI. Budget Effects and Vote of the Committee 1821
A. Committee Estimates 1821
B. Cost Estimate Prepared by CBO 1823
C. Administration Estimate of Financial Impact of Title IX 1827
D. Vote of the Committee 1829

VII. Other Matter To Be Discussed Under House Rules 1830

98TH CONGRESS
2d Session

HOUSE OF REPRESENTATIVES

REPT. 98-432
Part 2

TAX REFORM ACT OF 1984

MARCH 5, 1984.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

SUPPLEMENTAL REPORT

[To accompany H.R. 4170]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 4170) to provide for tax reform, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as further amended do pass.

The amendment is as follows:

31-409 O

MARCH 5, 1984

[Amendment in the Nature of a Substitute to H.R. 4170, Including an Amendment to the Amendment in the Nature of a Substitute Set Forth as Section 1006]

Strike out all after the enacting clause and insert in lieu thereof the following:

SECTION 1. SHORT TITLE; ETC.

(a) SHORT TITLE.—This Act may be cited as the "Tax Reform Act of 1984".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

(c) TABLE OF TITLES.—

Title I. Tax Freeze; Tax Reforms Generally.
Title II. Life Insurance Provisions.
Title III. Revision of Private Foundation Provisions.
Title IV. Tax Simplification.

Title V. Tax Treatment of Fringe Benefits.
Title VI. Technical Corrections.
Title VII. Tax-Exempt Bond Provisions.
Title VIII. Miscellaneous Revenue Matters.
Title IX. Social Security Disability Benefits Reform.
Title X. Medicare Budget Reconciliation Amendments.
Title XI. Trade Adjustment Assistance.
Title XII. Highway Revenue Provisions.

TITLE I—TAX FREEZE; TAX REFORMS GENERALLY

SEC. 10. TABLE OF CONTENTS.

Sec. 1. Short title; etc.

TITLE I—TAX FREEZE; TAX REFORMS GENERALLY

Sec. 10. Table of Contents.

Subtitle A—Deferral of Certain Tax Reductions

Sec. 11. Short title.

Part I—Income Tax Provisions

Sec. 12. Amount of used property eligible for investment tax credit.
Sec. 13. Finance lease provisions.
Sec. 14. Election to expense certain depreciable business assets.
Sec. 15. Employee stock ownership credit.
Sec. 16. Cost-of-living adjustments in pension plan limitations.
Sec. 17. Repeal of partial interest exclusion.
Sec. 18. Foreign earned income of individuals.

Part II—Estate and Gift Tax Rates

Sec. 21. Maximum rate.

Part III—Excise Taxes

Sec. 25. Tax rate on newly discovered oil.
Sec. 26. Excise tax on communications services.
Sec. 27. Excise tax on cigarettes and distilled spirits.

Subtitle B—Tax-Exempt Entity Leasing

Sec. 31. Short title.
Sec. 32. Denial of tax incentives for property used by governments and other tax-exempt entities.
Sec. 33. Study of present class life of certain high technology property.

Subtitle C—Treatment of Bonds and Other Debt Instruments

Sec. 41. Treatment of bonds and other debt instruments.
Sec. 42. Technical and conforming amendments related to original issue discount changes.

Sec. 43. Technical and conforming amendments related to treatment of market discount and acquisition discount.
Sec. 44. Effective dates.

Subtitle D—Corporate Provisions

Part I—Limitations on Dividends Received Deduction

Sec. 51. Dividends received deduction reduced where portfolio stock is debt financed.
Sec. 52. Treatment of dividends from regulated investment companies.

Part II—Treatment of Certain Distributions

Sec. 53. Corporate shareholder's basis in stock reduced by non-taxed portion of extraordinary dividends.
Sec. 54. Distribution of appreciated property by corporations.
Sec. 55. Extension of holding period for losses attributable to capital gain dividends of regulated investment companies or real estate investment trusts.

Part III—Miscellaneous Provisions

Sec. 56. Denial of deductions for certain expenses incurred in connection with short sales.
Sec. 57. Nonrecognition of gain or loss by corporation on options with respect to its stock.
Sec. 58. Amendments to accumulated earnings tax.
Sec. 59. Repeal of stock for debt exception for purposes of determining income from discharge of indebtedness.
Sec. 60. Distributions of obligations having original issue discount.
Sec. 61. Eligibility to file consolidated returns.

Subtitle E—Partnership Provisions

Sec. 71. Partnership allocations with respect to contributed property.
Sec. 72. Determination of distributive shares when partner's interest changes.
Sec. 73. Payments to partners for property or certain services.
Sec. 74. Contributions to a partnership of unrealized receivables, inventory items, or capital loss property.
Sec. 75. Transfers of partnership interests by corporations.
Sec. 76. Application of section 751 in the case of tiered partnerships.
Sec. 77. Section 1031 not applicable to partnership interests; limitation on the period during which like kind exchanges may be made.
Sec. 78. Elimination of basis strips under section 734(b).
Sec. 79. Overruling of Raphan case.

Subtitle F—Trust Provisions

Sec. 81. Treatment of property distributed in kind.
Sec. 82. Treatment of multiple trusts.

Subtitle G—Accounting Changes

Sec. 91. Certain amounts not treated as incurred before economic performance.

Subtitle H—Provisions Relating to Tax Straddles

Sec. 101. Repeal of exception from straddle rules for stock options and certain stock.

Sec. 102. Section 1256 extended to certain options.
Sec. 103. Regulations under section 1092(b).
Sec. 104. Limitation on losses from hedging transactions.
Sec. 105. Clarification that section 1234 applies to cash settlement options.

Subtitle I—Employee Benefit Provisions

PART I—WELFARE BENEFIT PLANS

Sec. 111. Treatment of funded welfare benefit plans.
Sec. 112. Treatment of unfunded deferred benefits.
Sec. 113. Additional requirements for tax-exempt status of certain organizations.
Sec. 114. Amendments to tax on unrelated business income.
Sec. 115. Employer and employee benefit association treated as related persons under section 1239.

PART II—OTHER PROVISIONS

Sec. 116. Treatment of certain medical, etc., benefits under section 415.
Sec. 117. Limitation on accrual of vacation pay.
Sec. 118. Determination of whether there is a collective bargaining agreement.
Sec. 119. Disqualification of plan where substantially all contributions are employee contributions.
Sec. 120. Participation and discrimination standards applicable to cash or deferred arrangements.

Subtitle J—Foreign Provisions

Sec. 131. Treatment of related person factoring income.
Sec. 132. Taxation of certain transfers of property outside the United States.
Sec. 133. Section 1248 to apply to certain indirect transfers of stock in a foreign corporation.
Sec. 134. Treatment of United States source original issue discount in case of foreign persons.
Sec. 135. Clarification of definition of articles produced in Puerto Rico or the Virgin Islands.
Sec. 136. Treatment of certain transportation income.
Sec. 137. Treatment of payments to Guam and Virgin Islands corporations.
Sec. 138. Application of collapsible corporation rules to foreign corporations.
Sec. 139. Definition of foreign investment company.
Sec. 140. Treatment of certain distributions received by United States-owned foreign corporations.
Sec. 141. Interest and dividends paid by certain United States-owned foreign corporations treated as derived from United States sources.
Sec. 142. Certain dividends treated as interest for purposes of the limitation on the foreign tax credit.

Subtitle K—Reporting, Penalty, and Other Provisions

Sec. 151. Organizers and sellers of potentially abusive tax shelters must keep lists of investors.
Sec. 152. Returns relating to mortgage interest received in trade or business.
Sec. 153. Returns relating to foreclosures and abandonments of security.
Sec. 154. Increase in penalty for promoting abusive tax shelters.
Sec. 155. Reporting of State and local refunds not required with respect to nonitemizers.

Sec. 156. Authorization to disregard appraisals of persons penalized for aiding in understatements of tax liability.
Sec. 157. Provisions relating to individual retirement accounts.
Sec. 158. Returns relating to exchanges of partnership interests where unrealized receivables, etc., involved.
Sec. 159. Statements required in case of certain substitute dividend payments.

Subtitle L—Miscellaneous Provisions

Sec. 161. Inclusion of tax benefit items in income.
Sec. 162. Loans with below-market interest rates.
Sec. 163. LIFO conformity rules applied on controlled group basis.
Sec. 164. Treatment of collapsible corporations.
Sec. 165. Eligibility for income averaging.
Sec. 166. Limitation on amount of depreciation and investment tax credit allowable for luxury automobiles.
Sec. 167. Amendments to section 1239.
Sec. 168. Amendments to section 267.

Subtitle A—Deferral of Certain Tax Reductions

SEC. 11. SHORT TITLE.

This subtitle may be cited as the "Tax Freeze Act of 1984".

PART I—INCOME TAX PROVISIONS

SEC. 12. AMOUNT OF USED PROPERTY ELIGIBLE FOR INVESTMENT TAX CREDIT.

(a) General Rule.—Subparagraph (A) of section 48(c)(2) (relating to dollar limitation on amount of used section 38 property) is amended—

(1) by striking out "$150,000 ($125,000 for taxable years beginning in 1981, 1982, 1983, or 1984)" and inserting in lieu thereof "$125,000 ($150,000 for taxable years beginning after 1987)", and

(2) by striking out "$150,000 (or $125,000" each place it appears and inserting in lieu thereof "$125,000 (or $150,000".

(b) TECHNICAL AMENDMENT.—Subparagraph (B) of section 48(c)(2) is amended by striking out "$75,000 ($62,500 for taxable years beginning in 1981, 1982, 1983, or 1984)" and inserting in lieu thereof $62,500 ($75,000 for taxable years beginning after 1987)".

SEC. 13. FINANCE LEASE PROVISIONS.

(a) FOUR-YEAR DEFERRAL OF FINANCE LEASE PROVISIONS.—

(1) IN GENERAL.—Subparagraph (A) of section 209(d)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by striking out "December 31, 1983" and inserting in lieu thereof "December 31, 1987".

(2) FINANCE LEASE PROVISIONS CONTINUE TO APPLY TO FARM PROPERTY.—Clause (i) of section 209(d)(1)(B) of such Act is amended by striking out "January 1, 1984" and inserting in lieu thereof "January 1, 1988".

(3) TECHNICAL AMENDMENTS.—

(A) Subclause (I) of section 168(f)(8)(B)(ii) (relating to requirement that only 40 percent of lessee's property may be treated as qualified), as amended by section 209 of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "1986" and inserting in lieu thereof "1990".

(B) Paragraph (4) of section 168(i) (relating to limitations), as so amended, is amended by striking out "1985" each place it appears and inserting in lieu thereof "1989".

(b) TERMINATION OF SAFE HARBOR LEASING RULES.—Paragraph (8) of section 168(f) of the Internal Revenue Code of 1954 (relating to special rules for leasing), as in effect after the amendments made by section 208 of the Tax Equity and Fiscal Responsibility Act of 1982 but before the amendments made by section 209 of such Act, shall not apply to agreements entered into after December 31, 1983. The preceding sentence shall not apply to property described in paragraph (5) of section 208(d) of such Act.

(c) PROHIBITION OF LEASING REGULATIONS.—The Secretary of the Treasury or his delegate shall not issue any regulations relating to the determination of whether any transaction is a lease during the period beginning on the date of the enactment of this Act and ending on December 31, 1987. The preceding sentence shall not apply to regulations issued to carry out the purposes of subtitle B of title I of this

Act or section 210 of the Tax Equity and Fiscal Responsibility Act of 1982.

(d) TRANSITIONAL RULES.—The amendments made by subsection (a) shall not apply with respect to any property if—

(1) a binding contract to acquire or to construct such property was entered into by the lessee before March 2, 1984, or

(2) such property was acquired by the lessee, or the construction of such property was begun, by or for the lessee, before March 2, 1984.

SEC. 14. ELECTION TO EXPENSE CERTAIN DEPRECIABLE BUSINESS ASSETS.

Paragraph (1) of section 179(b) (relating to dollar limitation) is amended by striking out the table contained therein and inserting in lieu thereof the following:

"If the taxable year begins in:	The applicable amount is:
1983, 1984, 1985, 1986, or 1987	$5,000
1988 or 1989	7,500
1990 or thereafter	10,000."

SEC. 15. EMPLOYEE STOCK OWNERSHIP CREDIT.

Subparagraph (B) of section 44G(a)(2) (relating to employee stock ownership credit), as in effect before the amendments made by title IV of this Act, is amended by striking out the table contained therein and inserting in lieu thereof the following:

“For aggregate compensation paid or accrued during a portion of the taxable year occurring in calendar year:	The applicable percentage is
1983, 1984, 1985, 1986, or 1987	0.5
1988 or thereafter	0.”

SEC. 16. COST-OF-LIVING ADJUSTMENTS IN PENSION PLAN LIMITATIONS.

(a) General Rule.—Paragraph (3) of section 415(d) (relating to freeze on adjustment to define contribution and benefit limits) is amended by striking out “January 1, 1986” and inserting in lieu thereof “January 1, 1988”.

(b) Technical Amendment.—Subparagraph (A) of section 415(d)(2) (defining base periods), as amended by section 235(b)(2)(B) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out “October 1, 1984” and inserting in lieu thereof “October 1, 1986”.

SEC. 17. REPEAL OF PARTIAL INTEREST EXCLUSION.

(a) General Rule.—Subsections (a) and (c) of section 302 of the Economic Recovery Tax Act of 1981 are hereby repealed, and the Internal Revenue Code of 1954 shall be applied and administered as if such subsections (and the amendments made by such subsections) had not been enacted.

(b) Conforming Amendment.—Paragraph (1) of section 57(a) is amended to read as follows:

"(1) EXCLUSION OF DIVIDENDS.—Any amount excluded from gross income for the taxable year under section 116."

SEC. 18. FOREIGN EARNED INCOME OF INDIVIDUALS.

Subparagraph (A) of section 911(b)(2) (relating to limitation on foreign earned income) is amended by striking out the table contained therein and inserting in lieu thereof the following:

"In the case of taxable years beginning in:	The annual rate is:
1983, 1984, 1985, 1986, or 1987	$80,000
1988	85,000
1989	90,000
1990 and thereafter	95,000."

SEC. 19. EFFECTIVE DATE.

The amendments made by this part shall apply to taxable years ending after December 31, 1983.

PART II—ESTATE AND GIFT TAX RATES

SEC. 21. MAXIMUM RATE.

(a) GENERAL RULE.—Paragraph (2) of section 2001(c) (relating to phase-in of 50 percent maximum rate) is amended—

(1) by striking out "1985" in subparagraph (A) and inserting in lieu thereof "1989",

(2) by striking out "1983" each place it appears in subparagraph (C) and inserting in lieu thereof "1983, 1984, 1985, 1986, or 1987", and

(3) by striking out "1984" each place it appears in subparagraph (D) and inserting in lieu thereof "1988".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to the estates of decedents dying after, and gifts made after, December 31, 1983.

PART III—EXCISE TAXES

SEC. 25. TAX RATE ON NEWLY DISCOVERED OIL.

(a) GENERAL RULE.—Subparagraph (B) of section 4987(b)(3) (relating to rate of tax on newly discovered oil) is amended by striking out the table contained therein and inserting in lieu thereof the following:

"For taxable periods beginning in:	The applicable percentage is:
1983, 1984, 1985, 1986, or 1987	25
1988	22½
1989	20
1990 and thereafter	15."

(b) CONTINUATION OF PERCENTAGE DEPLETION FOR OIL AND GAS FROM SECONDARY OR TERTIARY PROCESSES.—

(1) Paragraph (2) of section 613A(c) (relating to exemption for independent producers and royalty owners) is amended by striking out the last sentence.

(2) Subparagraph (A) of section 613A(c)(3) (defining depletable oil quantity) is amended by adding at the end thereof the following new sentence:

"Clause (ii) shall not apply after December 31, 1983."

(3) Subparagraph (E) of section 613A(c)(7) is amended by adding at the end thereof the following new sentence: "This subparagraph shall not apply after December 31, 1983."

(4) Subparagraph (A) of section 613A(c)(9) (relating to transfer of oil or gas property) is amended by striking out "paragraph (1)" and inserting in lieu thereof "this subsection".

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to taxable periods beginning after December 31, 1983.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall take effect on January 1, 1984.

SEC. 26. EXCISE TAX ON COMMUNICATIONS SERVICES.

Paragraph (2) of section 4251(b) (relating to rate of tax on communications services) is amended by striking out the table contained therein and inserting in lieu thereof the following:

"With respect to amounts paid pursuant to bills first rendered:	**The applicable percentage is:**
During 1983, 1984, 1985, 1986, or 1987	3
During 1988 or thereafter	0."

SEC. 27. EXCISE TAX ON CIGARETTES AND DISTILLED SPIRITS.

(a) CIGARETTES.—Subsection (b) of section 5701 (relating to tax on cigarettes) is amended to read as follows:

"(b) CIGARETTES.—

"(1) IN GENERAL.—On cigarettes, manufactured in or imported into the United States, there shall be imposed the following taxes:

"(A) SMALL CIGARETTES.—On small cigarettes, a tax at the rate per thousand determined in accordance with the following table:

"In the case of cigarettes removed:	The rate is:
Before October 1, 1985	$8
On or after October 1, 1985, and before January 1, 1988	6
On or after January 1, 1988	4

"(B) LARGE CIGARETTES.—On large cigarettes, a tax at the rate per thousand determined in accordance with the following table:

"In the case of cigarettes removed:	The rate is:
Before October 1, 1985	$16.80
On or after October 1, 1985, and before January 1, 1988	12.60
On or after January 1, 1988	8.40

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) SMALL CIGARETTES.—The term 'small cigarettes' means cigarettes weighing not more than 3 pounds per thousand.

"(B) LARGE CIGARETTES.—The term 'large cigarettes' means cigarettes weighing more than 3 pounds per thousand; except that, if more than 6½ inches in length, they shall be taxable as if they were small cigarettes, counting each 2¾ inches (or fraction thereof) of the length of each as 1 cigarette."

(b) DISTILLED SPIRITS.—

(1) IN GENERAL.—Paragraphs (1) and (3) of section 5001(a) (relating to rate of tax on distilled spirits) are each amended by striking out "$10.50" and inserting in lieu thereof "$10.50 ($14.25 during the period beginning on October 1, 1985, and ending on December 31, 1987)".

(2) TECHNICAL AMENDMENT.—Paragraphs (1) and (2) of section 5010(a) (relating to credit for wine content and for flavors content) are each amended by striking out "$10.50" and inserting in lieu thereof "the rate at which such distilled spirits were subject to tax under section 5001 (or section 7652)".

(c) FLOOR STOCKS TAXES ON DISTILLED SPIRITS.—

(1) IMPOSITION OF TAX.—On distilled spirits produced in or imported into the United States which are removed before October 1, 1985, and held on such date for sale by any person, there shall be imposed a

tax at the rate of $3.75 for each proof gallon and a proportionate tax at the like rate on all fractional parts of a proof gallon.

(2) LIABILITY FOR TAX AND METHOD OF PAYMENT.—

(A) LIABILITY FOR TAX.—A person holding distilled spirits on October 1, 1985, to which the tax imposed by paragraph (1) applies shall be liable for such tax.

(B) METHOD OF PAYMENT.—The tax imposed by paragraph (1)—

(i) shall be paid in such manner as the Secretary shall by regulations prescribe, and

(ii) shall be paid at such date (not later than 6 months after the date of the enactment of this Act) as the Secretary shall by regulations prescribe.

(3) EXCEPTION FOR ON-PREMISES RETAIL ESTABLISHMENTS.—To the extent provided in regulations prescribed by the Secretary, the tax imposed by paragraph (1) shall not apply to distilled spirits held on October 1, 1985, on the premises of a retail establishment where alcoholic beverages are sold for consumption on the premises only.

(4) DEFINITIONS.—For purposes of this subsection—

(A) DISTILLED SPIRITS.—The term "distilled spirits" has the meaning given such term by section 5002(a)(8) of the Internal Revenue Code of 1954.

(B) TREATMENT OF IMPORTED PERFUMES CONTAINING DISTILLED SPIRITS.—Any article described in section 5001(a)(3) of such Code shall be treated as distilled spirits; except that the tax imposed by paragraph (1) shall be imposed on a wine gallon basis in lieu of a proof gallon basis.

(d) FLOOR STOCKS REFUNDS.—

(1) IN GENERAL.—Where, before a tax reduction date, any tax-reduced article has been sold by the manufacturer, producer, or importer and on such day is held for sale by any person (hereinafter in this subsection referred to as the "dealer"), there shall be credited or refunded (without interest) to the manufacturer, producer, or importer an amount equal to the excess of the tax paid by such manufacturer, producer, or importer on such article over the tax which would have been paid if such article were taxed at the rate in effect on the tax reduction date if—

(A) claim for such credit or refund is filed with the Secretary before the day 9 months after the tax reduction date based on a request submitted to the manufacturer, producer, or importer before the day 6 months after the tax reduction date by the dealer who held the article in respect of which the credit or refund is claimed, and

(B) on or before the day 9 months after the tax reduction date, reimbursement has been made to the dealer by the manufacturer, producer, or importer in an amount equal to such excess or written consent has been obtained from the dealer to the allowance of the credit or refund.

(2) LIMITATION ON ELIGIBILITY FOR CREDIT OR REFUND.—No manufacturer, producer, or importer shall be entitled to credit or refund under paragraph (1) unless he has in his possession such evidence of the inventories with respect to which the refund or credit is claimed as may be required by regulations prescribed by the Secretary.

(3) OTHER LAWS APPLICABLE.—All provisions of law, including penalties applicable with respect to the taxes imposed by section 5001 or 5701 (whichever is appropriate) shall, insofar as applicable and not inconsistent with paragraphs (1) and (2) of this subsection,

apply in respect of the credits and refunds provided for in paragraph (1) to the same extent as if the credits or refunds constituted overpayments of the tax.

(4) DEFINITIONS.—For purposes of this subsection—

(A) TAX REDUCTION DATE.—The term "tax reduction date" means—

(i) in the case of articles subject to tax under section 5001 of the Internal Revenue Code of 1954, January 1, 1988, and

(ii) in the case of articles subject to tax under section 5701(b) of such Code, October 1, 1985, and January 1, 1988.

(B) TAX-REDUCED ARTICLE.—The term "tax-reduced article" means any article subject to tax under section 5001 or 5701(b) of such Code.

(e) DEFINITIONS FOR PURPOSES OF SUBSECTIONS (c) AND (d).—For purposes of subsections (c) and (d)—

(1) PERSON.—The term "person" includes any State or political subdivision thereof, or any agency or instrumentality of a State or political subdivision thereof.

(2) SECRETARY.—The term "Secretary" means the Secretary of the Treasury or his delegate.

Subtitle B—Tax-Exempt Entity Leasing

SEC. 31. SHORT TITLE.

This subtitle may be cited as the "Tax-Exempt Entity Leasing Tax Act of 1984".

SEC. 32. DENIAL OF TAX INCENTIVES FOR PROPERTY USED BY GOVERNMENTS AND OTHER TAX-EXEMPT ENTITIES.

(a) General Rule.—Section 168 of the Internal Revenue Code of 1954 (relating to accelerated cost recovery system) is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

"(j) Property Used by Governments and Other Tax-Exempt Entities.—

"(1) In general.—Notwithstanding any other provision of this section, the deduction allowed under subsection (a) (and any other deduction allowable for depreciation or amortization) for any taxable year with respect to tax-exempt use property shall be determined—

"(A) by using the straight-line method (without regard to salvage value), and

"(B) by using a recovery period determined under the following table:

"In the case of:	The recovery period shall be:
(I) Property not described in subclause (II) or subclause (III)	The present class life
(II) Personal property with no present class life	12 years
(III) 15-year real property	40 years

"(2) OPERATING RULES.—

"(A) RECOVERY PERIOD MUST AT LEAST EQUAL LEASE TERM.—In the case of any tax-exempt use property used by the tax-exempt entity pursuant to a lease, the recovery period used for purposes of paragraph (1) shall not be less than—

"(i) except as provided in clause (ii), the lease term, or

"(ii) in the case of 15-year real property, 125 percent of the lease term.

"(B) CONVENTIONS.—

"(i) PROPERTY OTHER THAN 15-YEAR REAL PROPERTY.—In the case of property other than 15-year real property, the half-year convention shall apply for purposes of paragraph (1).

"(ii) 15-YEAR REAL PROPERTY.—In the case of 15-year real property, the amount determined under paragraph (1) shall be determined on the basis of the number of months in the year in which the property is in service.

"(C) EXCEPTION WHERE LONGER RECOVERY PERIOD APPLIES.—Paragraph (1) shall not apply to any recovery property if the recovery period which would apply to such property by reason of an election under subsection (b)(3) exceeds the recovery period for such property determined under this subsection.

"(D) DETERMINATION OF CLASS FOR PROPERTY WHICH IS NOT RECOVERY PROPERTY.—In the case of any property which is not recovery property, for purposes of this subsection, the determination of whether such property is 15-year real property shall be made as if such property were recovery property.

"(E) COORDINATION WITH SUBSECTION (f)(12).—Paragraph (12) of subsection (f) shall not apply to any tax-exempt use property to which this subsection applies.

"(3) TAX-EXEMPT USE PROPERTY.—For purposes of this subsection—

"(A) PROPERTY OTHER THAN 15-YEAR REAL PROPERTY.—Except as otherwise provided in this subsection, the term 'tax-exempt use property' means any tangible property used by a tax-exempt entity.

"(B) 15-YEAR REAL PROPERTY.—

"(i) IN GENERAL.—In the case of 15-year real property, the term 'tax-exempt use property' means that portion of the property used by a tax-exempt entity in a disqualified use.

"(ii) DISQUALIFIED USE.—For purposes of this subparagraph, the term 'disqualified use' means any use of the property by a tax-exempt entity, but only if—

"(I) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103 and such entity (or a related entity) participated in such financing,

"(II) such use is pursuant to a lease under which there is a fixed or determinable price purchase or sale option which involves such entity (or a related entity) or there is the equivalent of such an option, "(III) such use is pursuant to a lease which has a lease term in excess of 80 percent of the property's useful life, or

"(IV) such use occurs after a sale (or other transfer) of the property by, or lease of the property from, such entity (or a related entity).

"(iii) 20-PERCENT THRESHOLD TEST.—Clause (i) shall apply to any property only if the portion of such property used by tax-exempt entities in disqualified uses is more than 20 percent of the property.

"(iv) TREATMENT OF IMPROVEMENTS.—For purposes of this subparagraph, improvements to a property (other than land) shall not be treated as a separate property.

"(C) EXCEPTION FOR SHORT-TERM LEASES.—

"(i) IN GENERAL.—Property shall not be treated as used by a tax-exempt entity merely by reason of use pursuant to a short-term lease.

"(ii) PROPERTY OTHER THAN 15-YEAR PROPERTY.—For purposes of this subparagraph, except as provided in clause (iii), the term 'short-term lease' means any lease which has a lease term less than the greater of—

"(I) 1 year, or

"(II) 30 percent of the property's present class life (to the extent such present class life does not exceed 10 years).

"(iii) 15-YEAR REAL PROPERTY.—For purposes of this subparagraph, in the case of 15-year real property, the term 'short-term lease' means any lease which has a lease term of less than 3 years.

"(D) EXCEPTION WHERE PROPERTY USED IN UNRELATED TRADE OR BUSINESS.—The term 'tax-exempt use property' shall not include any portion of a property predominantly used by the tax-exempt entity in an unrelated trade or business the income of which is subject to tax under section 511.

"(4) TAX-EXEMPT ENTITY.—

"(A) IN GENERAL.—For purposes of this subsection, the term 'tax-exempt entity' means—

"(i) the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing,

"(ii) an organization (other than a cooperative described in section 521) which is exempt from tax imposed by this chapter, and

"(iii) any foreign person or entity.

"(B) EXCEPTIONS FOR CERTAIN PROPERTY USED BY FOREIGN PERSON OR ENTITY.—

"(i) INCOME FROM PROPERTY SUBJECT TO UNITED STATES TAX.—Clause (iii) of subparagraph (A) shall not apply with respect to any property if more than 50 percent of the gross income for the taxable year derived by the foreign person or entity from the use of such property is subject to tax under this chapter. For purposes of the preceding sentence, any exclusion or exemption shall not apply for purposes of determining the amount of the gross income so derived, but shall apply for purposes of determining the portion of such gross income subject to tax under this chapter.

"(ii) MOVIES.—Clause (iii) of subparagraph (A) shall not apply with respect to any qualified film (as defined in section 48(k)(1)(B)).

"(C) FOREIGN PERSON OR ENTITY.—For purposes of this paragraph, the term 'foreign person or entity' means—

"(i) any foreign government, any international organization, or any agency or instrumentality of any of the foregoing, and

"(ii) any person who is not a United States person.

"(D) TREATMENT OF CERTAIN TAXABLE INSTRUMENTALITIES.—For purposes of this subsection and paragraph (5) of section 48(a), a corporation shall not be treated as an instrumentality of the United States or of any State or political subdivision thereof if—

"(i) all of the activities of such corporation are subject to tax under this chapter, and

"(ii) a majority of the board of directors of such corporation is not selected by the United States or any State or political subdivision thereof.

"(E) CERTAIN PREVIOUSLY TAX-EXEMPT ORGANIZATIONS.—For purposes of this subsection and paragraph (4) of section 48(a), an organization shall be treated as an organization described in subparagraph (A)(ii) with respect to any property of which such organization is the lessee if such organization (or a predecessor organization which was engaged in substantially similar activities) was an organization (other than a cooperative described in section 521) exempt from tax imposed by this chapter at any time during the 5-year period ending on the date such organization first used such property.

"(5) SPECIAL RULES FOR CERTAIN HIGH TECHNOLOGY EQUIPMENT.—

"(A) EXEMPTION WHERE LEASE TERM IS 5 YEARS OR LESS AND FOR FOREIGN USE PROPERTY.—For purposes of this subsection, the term 'tax-exempt use property' shall not include any qualified technological equipment if—

"(i) the use of the tax-exempt entity is pursuant to a lease which has a lease term of 5 years or less, or

"(ii) subsection (f)(2) applies to such property.

"(B) RECOVERY PERIOD WHERE LEASE TERM IS GREATER THAN 5 YEARS.—In the case of any qualified technological equipment not described in subparagraph (A), the recovery period used for purposes of paragraph (1) shall be 5 years.

"(C) QUALIFIED TECHNOLOGICAL EQUIPMENT.—For purposes of this paragraph—

"(i) IN GENERAL.—Except as provided in clause (ii), the term 'qualified technological equipment' means—

"(I) any computer or peripheral equipment,

"(II) any high technology telephone station equipment installed on the customer's premises, and

"(III) any high technology medical equipment.

"(ii) EXCEPTION FOR CERTAIN PROPERTY.—The term 'qualified technological equipment' shall not include any property used by a tax-exempt entity if—

"(I) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103,

"(II) such use occurs after a sale (or other transfer) of the property by, or lease of such property from, such entity (or related entity) and such property has been used by such entity (or a related entity) before such sale (or other transfer) or lease, or

"(III) such tax-exempt entity is the United States or any agency or instrumentality of the United States.

"(D) COMPUTER OR PERIPHERAL EQUIPMENT DEFINED.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'computer or peripheral equipment' means—

"(I) any computer, and

"(II) any related peripheral equipment.

"(ii) COMPUTER.—The term 'computer' means a programmable electronically activated device which—

"(I) is capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention, and

"(II) consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities.

"(iii) RELATED PERIPHERAL EQUIPMENT.—The term 'related peripheral equipment' means any auxiliary machine (whether on-line or off-line) which is designed to be placed under the control of the central processing unit of a computer.

"(iv) EXCEPTIONS.—The term 'computer or related peripheral equipment' shall not include—

"(I) any equipment which is an integral part of other property which is not a computer,

"(II) typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and

"(III) equipment of a kind used primarily for amusement or entertainment of the user.

"(E) HIGH TECHNOLOGY MEDICAL EQUIPMENT.—For purposes of this paragraph, the term 'high technology medical equipment' means any electronic, electromechanical, or computer-based high technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of patients in a laboratory, medical, or hospital environment.

"(6) OTHER SPECIAL RULES.—

"(A) LEASE TERM.—In determining a lease term for purposes of this subsection—

"(i) there shall be taken into account options to renew, and

"(ii) 2 or more successive leases with respect to the same or substantially similar property shall be treated as 1 lease.

"(B) TREATMENT OF CERTAIN CONTRACTS FOR PROVIDING SERVICES, ETC.—

"(i) IN GENERAL.—For purposes of this subsection and paragraphs (4) and (5) of section 48(a), a contract which purports to be a service contract shall not be treated as a service contract if such contract is more properly treated as a lease of property, taking into account all relevant factors including whether or not—

"(I) the tax-exempt entity is in physical possession of the property,

"(II) such entity controls the property,

"(III) such entity has a significant economic or possessory interest in the property,

"(IV) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,

"(V) the service provider does not use the property concurrently to provide significant services to entities unrelated to the tax-exempt entity, and

"(VI) the total contract price does not substantially exceed the rental value of the property for the contract period.

"(ii) OTHER ARRANGEMENTS.—For purposes of this subsection and paragraphs

(4) and (5) of section 48(a), an arrangement (including a partnership or other pass-thru entity) which is not a service contract and purports not to be a lease shall be treated as a lease if such arrangement is more properly treated as a lease, taking into account all relevant factors including factors similar to those set forth in clause (i).

"(C) EXCEPTION FOR CERTAIN SOLID WASTE DISPOSAL FACILITIES.—For purposes of this subsection—

"(i) IN GENERAL.—The term 'tax-exempt use property' shall not include any qualified solid waste disposal facility.

"(ii) QUALIFIED SOLID WASTE DISPOSAL FACILITY.—For purposes of clause (i), the term 'qualified solid waste disposal facility' means any facility if—

"(I) such facility provides solid waste disposal services for residents of part or all of 1 or more governmental units and substantially all of the solid waste processed at such facility is collected from the general public, "(II) such facility produces marketable quantities of steam, hot water, or electricity,

"(III) the tax-exempt entity does not control the facility and is not in physical possession of the facility, and

"(IV) the service provider bears any risk of substantially diminished receipts or increased expenditures if there is nonperformance under the contract.

"(D) SPECIAL RULES FOR CERTAIN INTERNATIONAL ORGANIZATIONS.—If any domestic corporation which is not a tax-exempt entity is a member of the International Telecommunications Satellite Consortium, the International Maritime Satellite Organization, or any successor organization of such Consortium or Organization, the term 'tax exempt use property' shall not include such domestic corporation's proportionate share (determined after the application of paragraph (8) to tax-exempt entities) of property held by such Consortium, Organization, or successor organization.

"(7) RELATED ENTITIES.—For purposes of this subsection—

"(A)(i) Each governmental unit and each agency or instrumentality of a governmental unit is related to each other such unit, agency, or instrumentality which directly or indirectly derives its powers, rights, and duties in whole or in part from the same sovereign authority.

"(ii) For purposes of clause (i), the United States, each State, and each possession of the United States shall be treated as a separate sovereign authority.

"(B) Any entity not described in subparagraph (A)(i) is related to any other entity if the 2 entities have—

"(i) significant common purposes and substantial common membership, or

"(ii) directly or indirectly substantial common direction or control.

"(C)(i) An entity is related to another entity if either entity owns (directly or through 1 or more entities) a 50 percent or greater interest in the capital or profits of the other entity.

"(ii) For purposes of clause (i), entities treated as related under subparagraph (A) or (B) shall be treated as 1 entity.

"(D) An entity is related to another entity with respect to a transaction if such transaction is part of an attempt by such entities to avoid the application of this subsection, paragraph (4) or (5) of section 48(a), or clause (vi) of section 48(g)(2)(B).

"(8) TREATMENT OF PARTNERSHIPS, ETC.—

"(A) IN GENERAL.—If—

"(i) any property which (but for this subparagraph) is not tax-exempt use property is held by a partnership which has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, and

"(ii) the allocation to the tax-exempt entity of partnership items is not a qualified allocation,

such tax-exempt entity's proportionate share of such property shall be treated as tax-exempt use property.

"(B) QUALIFIED ALLOCATION.—For purposes of subparagraph (A), the term 'qualified allocation' means any allocation under the partnership agreement to a tax-exempt entity which—

"(i) results in such entity's being allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis and such share remains the same during the entire period the entity is a partner in the partnership, and

"(ii) meets the requirements of section 704(b)(2).

For purposes of clause (i), items allocated under section 704(c) shall not be taken into account.

"(C) DETERMINATION OF PROPORTIONATE SHARE.—

"(i) IN GENERAL.—For purposes of subparagraph (A), a tax-exempt entity's proportionate share of any property held by a partnership shall be determined on the basis of such entity's share of partnership distributions or partnership items of income or gain (excluding gain allocated under section 704(c)), whichever results in the largest proportionate share.

"(ii) DETERMINATION WHERE ALLOCATIONS VARY.—For purposes of clause (i), if, under the partnership agreement, a tax-exempt entity's share of partnership distributions or partnership items of income or gain (excluding gain allocated under section

704(c)), may vary during the period such entity is a partner in the partnership, such share shall be the highest share such entity may receive under such agreement.

"(D) OTHER PASS-THRU ENTITIES.—Rules similar to the rules of subparagraphs (A), (B), and (C) shall also apply in the case of any trust or other pass-thru entity.

"(9) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection."

(b) DENIAL OF INVESTMENT TAX CREDIT FOR PROPERTY USED BY FOREIGN GOVERNMENTS AND OTHER FOREIGN PERSONS.—

(1) Paragraph (5) of section 48(a) (relating to property used by governmental units) is amended by striking out the first two sentences and inserting in lieu thereof the following: "Property used—

"(A) by the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing, or

"(B) by any foreign person or entity (as defined in section 168(j)(4)(C)), but only with respect to property to which section 168(j)(4)(A)(iii) applies (determined after the application of section 168(j)(4)(B)),

shall not be treated as section 38 property. The preceding sentence shall not apply to any property to the extent such property is treated as not being tax-exempt use property under section 168(j)(6)(D) (relating to special rule for certain international organizations)."

(2) The heading of paragraph (5) of section 48(a) is amended by striking out "GOVERNMENTAL UNITS" and inserting in lieu thereof "GOVERNMENTAL UNITS AND CERTAIN FOREIGN PERSONS".

(c) REHABILITATION CREDIT NOT TO APPLY WHERE PROPERTY FINANCED BY TAX-EXEMPT BONDS AND USED BY TAX-EXEMPT ENTITY.—

(1) IN GENERAL.—Subparagraph (B) of section 48(g)(2) (relating to certain expenditures not treated as qualified rehabilitation expenditures) is amended by adding at the end thereof the following new clause:

"(vi) TAX-EXEMPT FINANCING OF PROPERTY USED BY TAX-EXEMPT ENTITIES.—Any expenditure in connection with the rehabilitation of the portion of a building which is tax-exempt use property if any portion of—

"(I) the cost of acquiring such building or any interest therein, or

"(II) the expenditures in connection with such rehabilitation,

is financed (directly or indirectly) by an obligation the interest on which is exempt from taxation under section 103. For purposes of the preceding sentence, the term 'tax-exempt use property' has the meaning given to such term by section 168(j)(3), except that '1 year' shall be substituted for '3 years' in section 168(j)(3)(C)(iii). This clause shall not apply for purposes of determining under paragraph (1)(C) whether a building has been substantially rehabilitated."

(2) TECHNICAL AMENDMENT.—Clause (i) of section 48(g)(2)(B) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply to any expenditure to the extent subsection (f)(12) or (j) of section 168 applies to such expenditure."

(d) AUTHORITY TO PRESCRIBE PRESENT CLASS LIFE FOR CERTAIN PROPERTY.—Paragraph (2) of section 168(g) (defining present class life) is amended by adding at the end thereof the following new sentence: "If any property (other than section 1250 class property) does not have a present class life within the meaning of the preceding sentence, the Secretary may prescribe a present class life for such property which reasonably reflects the anticipated useful life of such property to the industry or other group."

(e) INVESTMENT TAX CREDIT ALLOWABLE WITH RESPECT TO CERTAIN SOLID WASTE DISPOSAL FACILITIES.—Paragraph (5) of section 48(a) (relating to property used by governmental units) is amended by adding at the end thereof the following new sentence: "This paragraph shall not apply to any qualified solid waste disposal facility (within the meaning of section 168(j)(6)(C))."

(f) CROSS REFERENCE.—Paragraph (5) of section 48(a) is amended by adding at the end thereof the following new sentence: "For provisions providing special rules for application of this paragraph and paragraph (4), see section 168(j)."

(g) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply—

(A) to property placed in service by the taxpayer after May 23, 1983, in taxable years ending after such date, and

(B) to property placed in service by the taxpayer on or before May 23, 1983, if the use by the tax-exempt entity is pursuant to a lease entered into after May 23, 1983.

(2) LEASES ENTERED INTO ON OR BEFORE MAY 23, 1983.—The amendments made by this section shall not apply with respect to any property used by a tax-exempt entity if such use is pursuant to—

(A) a lease entered into on or before May 23, 1983 (or a sublease under such a lease), or

(B) any renewal or extension of a lease entered into on or before May 23, 1983, if such renewal or extension is pursuant to an option exercisable by the tax-exempt entity which was contained in such lease on May 23, 1983.

(3) BINDING CONTRACTS, ETC.—

(A) The amendments made by this section shall not apply with respect to any property used by a tax-exempt entity if such use is pursuant to 1 or more written binding contracts which, on May 23, 1983, and at all times thereafter, required—

(i) the taxpayer (or his predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate such property, and

(ii) the tax-exempt entity (or a tax-exempt predecessor thereof) to use such property.

(B) The amendments made by this section shall not apply with respect to any property used by a tax-exempt entity—

(i) if—

(I) on or before May 23, 1983, the taxpayer (or his predecessor in interest under the contract) or the tax-exempt entity entered into a written binding contract to acquire, construct, reconstruct, or rehabilitate such property and such property had not previously been used by the tax-exempt entity, or

(II) the taxpayer or the tax-exempt entity acquired the property or completed the construction, reconstruction, or rehabilitation of the property after December 31, 1982, and on or before May 23, 1983, and

(ii) if—

(I) such use is pursuant to a written binding contract entered into before January 1, 1984, which requires the tax-exempt entity to use such property, or

(II) the tax-exempt entity had, in writing, indicated on or before May 23, 1983, a firm plan to enter into a written contract for the use of such property.

(4) OFFICIAL GOVERNMENTAL ACTION ON OR BEFORE MAY 23, 1983.—

(A) IN GENERAL.—The amendments made by this section shall not apply with respect to any property used by a tax-exempt entity (other than the United States, any agency or instrumentality thereof, or any foreign person or entity) if—

(i) on or before May 23, 1983—

(I) there was significant official governmental action approving the project or its design, and

(II) the aggregate amount paid or incurred with respect to the project exceeded the lesser of $100,000 or one-half of 1 percent of the estimated cost of the project, and

(ii) the use by the tax-exempt entity is pursuant to a written binding contract entered into before January 1, 1984, which requires the tax-exempt entity to use the property.

(B) SIGNIFICANT OFFICIAL GOVERNMENTAL ACTION.—For purposes of subparagraph (A), the term "significant official governmental action" does not include granting of permits, zoning changes, environmental impact statements, or similar governmental actions.

(5) MASS COMMUTING VEHICLES.—The amendments made by this section shall not apply to any qualified mass commuting vehicle (as defined in section 103(b)(9) of the Internal Revenue Code of 1954) which is financed in whole or in part by obligations the interest on which is excludable from gross income under section 103(a) of such Code if—

(A) such vehicle is placed in service before January 1, 1988, or

(B) such vehicle is placed in service on or after such date—

(i) pursuant to a binding contract or commitment entered into before April 1, 1983, and

(ii) solely because of conditions which, as determined by the Secretary of the Treasury or his delegate, are not within the control of the lessor or lessee.

(6) CERTAIN TURBINES AND BOILERS.—The amendments made by this section shall not apply to any property described in section 208(d)(3)(E) of the Tax Equity and Fiscal Responsibility Act of 1982.

(7) CERTAIN FACILITIES FOR WHICH RULING REQUESTS FILED ON OR BEFORE MAY 23, 1983.—The amendments made by this section shall not apply with respect to any facilities described in clause (ii) of section 168(f)(12)(C) of the Internal Revenue Code of 1954 (relating to certain sewage or solid waste disposal facilities), as in effect on the day before the date of the enactment of this Act, if a ruling request with respect to the use of such facility by the tax-exempt entity was filed with the Internal Revenue Service on or before May 23, 1983.

(8) RECOVERY PERIOD FOR CERTAIN QUALIFIED SEWAGE FACILITIES.—

(A) IN GENERAL.—In the case of any property (other than 15-year real property) which is part of a qualified sewage facility, the recovery period used for purposes of paragraph (1) of section 168(j) of the Internal Revenue Code of 1954 (as added by this section) shall be 12 years.

(B) QUALIFIED SEWAGE FACILITIES.—For purposes of subparagraph (A), the term "qualified sewage facilities" means any facilities which are part of the sewer system of a city, if—

(i) on June 15, 1983, the City Council approved a resolution under which the city authorized the procurement of equity investments for such facilities, and

(ii) on July 12, 1983, the Industrial Development Board of the city approved a resolution to issue a $100,000,000 industrial development bond issue to provide funds to purchase such facilities.

(9) SPECIAL RULE FOR CERTAIN PARTNERSHIPS ORGANIZED BEFORE OCTOBER 21, 1983.—Paragraph (8) of section 168(j) of the Internal Revenue Code of 1954 (as added by this section) shall not apply to property held by any partnership if—

(A) such property was acquired by such partnership before January 1, 1985,

(B) before October 21, 1983, such partnership was organized and publicly announced the maximum amount of interests which would be sold in the partnership, and

(C) the marketing of partnership interests in such partnership was completed not later than the 90th day after the date of the enactment of this Act and the aggregate amount of interests in such partnership sold does not exceed the maximum amount described in subparagraph (B).

(10) DEFINITIONS.—For purposes of this subsection—

(A) TAX-EXEMPT ENTITY.—The term "tax-exempt entity" has the same meaning as when used in section 168(j) of the Internal Revenue Code of 1954 (as added by this section), except that such term shall include any related entity (within the meaning of such section).

(B) FOREIGN PERSON OR ENTITY.—The term "foreign person or entity" has the meaning given to such term by section 168(j)(4)(C) of such Code (as added by this section).

SEC. 33. STUDY OF PRESENT CLASS LIFE OF CERTAIN HIGH TECHNOLOGY PROPERTY.

(a) GENERAL RULE.—The Secretary of the Treasury or his delegate shall conduct a study of the present class lives of property which is qualified technological property (as defined in section 168(j)(5)(C) of the Internal Revenue Code of 1954 without regard to clause (ii) thereof).

(b) REPORT TO THE CONGRESS.—Not later than July 1, 1984, the Secretary of the Treasury or his delegate shall submit a report to the Congress on the study conducted under subsection (a), together with such recommendations as he may deem advisable.

Subtitle C—Treatment of Bonds and Other Debt Instruments

SEC. 41. TREATMENT OF BONDS AND OTHER DEBT INSTRUMENTS.

(a) GENERAL RULE.—Subchapter P of chapter 1 (relating to special rules for capital gains and losses) is amended by adding at the end thereof the following new part:

"PART V—SPECIAL RULES FOR BONDS AND OTHER DEBT INSTRUMENTS

"Subpart A. Original issue discount.
"Subpart B. Market discount.
"Subpart C. Discount on short-term obligations.
"Subpart D. Miscellaneous provisions.

"Subpart A—Original Issue Discount

"Sec. 1271. Treatment of amounts received on retirement or sale or exchange of debt instruments.
"Sec. 1272. Current inclusion in income of original issue discount.
"Sec. 1273. Determination of amount of original issue discount.
"Sec. 1274. Determination of issue price in the case of certain debt instruments issued for property.
"Sec. 1275. Other definitions and special rules.

"SEC. 1271. TREATMENT OF AMOUNTS RECEIVED ON RETIREMENT OR SALE OR EXCHANGE OF DEBT INSTRUMENTS.

"(a) General Rule.—For purposes of this subtitle, in the case of debt instruments which are capital assets in the hands of the taxpayer—

"(1) Retirement.—Amounts received by the holder on retirement of such debt instruments shall be considered as amounts received in exchange therefor.

"(2) Sale or exchange.—

"(A) In general.—

"(i) Capital gain treatment.—On the sale or exchange of debt instruments held by the taxpayer more than 1 year, any gain realized shall (except as provided in clause (ii)) be considered gain from the sale or exchange of a capital asset held for more than 1 year.

"(ii) Special rule where intention to call debt instrument before maturity.—If at the time of original issue there was an intention to call any such debt instrument before maturity, any gain realized on the sale or exchange thereof which does not exceed an amount equal to the original issue discount reduced by the portion of original issue discount previously includible in the gross income of any holder (without regard to subsection (a)(6) or (b)(4) of section 1272 (or the corresponding provisions of prior law)) shall be considered as ordinary income.

"(B) EXCEPTIONS.—This paragraph (and paragraph (2) of subsection (c)) shall not apply to—

"(i) any tax-exempt obligation, or

"(ii) any holder who has purchased the debt instrument at a premium.

"(C) DOUBLE INCLUSION IN INCOME NOT REQUIRED.—This section and sections 1272 and 1286 shall not require the inclusion of any amount previously includible in gross income.

"(3) CERTAIN SHORT-TERM GOVERNMENT OBLIGATIONS.—

"(A) IN GENERAL.—On the sale or exchange of any short-term Government obligation, any gain realized which does not exceed an amount equal to the ratable share of the acquisition discount shall be treated as ordinary income. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held less than 1 year.

"(B) SHORT-TERM GOVERNMENT OBLIGATION.—For purposes of this paragraph, the term 'short-term Government obligation' means any obligation of the United States or any of its possessions, or of a State or any political subdivision thereof, or of the District of Columbia which is—

"(i) issued on a discount basis, and

"(ii) payable without interest at a fixed maturity date not exceeding 1 year from the date of issue.

Such term does not include any tax-exempt obligation.

"(C) ACQUISITION DISCOUNT.—For purposes of this pararaph, the term 'acquisition discount' means the excess of the stated redemption price at maturity over the taxpayer's basis for the obligation.

"(D) RATABLE SHARE.—For purposes of this paragraph, the ratable share of the acquisition discount is an amount which bears the same ratio to such discount as—

"(i) the number of days which the taxpayer held the obligation, bears to "(ii) the number of days after the date the taxpayer acquired the obligation and up to (and including) the date of its maturity.

"(b) EXCEPTIONS.—This section shall not apply to—

"(1) NATURAL PERSONS.—Any obligation issued by a natural person.

"(2) OBLIGATIONS ISSUED BEFORE JULY 2, 1982, BY CERTAIN ISSUERS.—Any obligation issued before July 2, 1982, by an issuer which—

"(A) is not a corporation, and

"(B) is not a government or political subdivision thereof.

"(c) TRANSITION RULES.—

"(1) SPECIAL RULE FOR CERTAIN OBLIGATIONS ISSUED BEFORE JANUARY 1, 1955.—Paragraph (1) of subsection (a) shall apply to a debt instrument issued before January 1, 1955, only if such instrument was issued with interest coupons or in registered form, or was in such form on March 1, 1954.

"(2) SPECIAL RULE FOR CERTAIN OBLIGATIONS TO WHICH SECTION 1272 DOES NOT APPLY.—

"(A) IN GENERAL.—On the sale or exchange of debt instruments issued by a government or political subdivision thereof after December 31, 1954, and before July 2, 1982, or by a corporation after December 31, 1954, and on or before May 27, 1969, held by the taxpayer more than 1 year, any gain realized which does not exceed—

"(i) an amount equal to the original issue discount, or

"(ii) if at the time of original issue there was no intention to call the debt instrument before maturity, an amount which bears the same ratio to the original issue discount as the number of complete months that the debt instrument was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity,

shall be considered as ordinary income. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 1 year.

"(B) SUBSECTION (a)(2)(A) NOT TO APPLY.—Subsection (a)(2)(A) shall not apply to any debt instrument referred to in subparagraph (A) of this paragraph.

"SEC. 1272. CURRENT INCLUSION IN INCOME OF ORIGINAL ISSUE DISCOUNT.

"(a) ORIGINAL ISSUE DISCOUNT ON DEBT INSTRUMENTS ISSUED AFTER JULY 1, 1982, INCLUDED IN INCOME ON BASIS OF CONSTANT INTEREST RATE.—

"(1) GENERAL RULE.—For purposes of this subtitle, there shall be included in the gross income of the holder of any debt instrument having original issue discount issued after July 1, 1982, an amount equal to the sum of the daily portions of the original issue discount for each day during the taxable year on which such holder held such debt instrument.

"(2) EXCEPTIONS.—Paragraph (1) shall not apply to—

"(A) TAX-EXEMPT OBLIGATIONS.—Any tax-exempt obligation.

"(B) UNITED STATES SAVINGS BONDS.—Any United States savings bond.

"(C) SHORT-TERM GOVERNMENT OBLIGATIONS.—Any short-term government obligation (within the meaning of section 1271(a)(3)).

"(D) OBLIGATIONS ISSUED BY NATURAL PERSONS BEFORE MARCH 2, 1984.—Any obligation issued by a natural person before March 2, 1984.

"(3) DETERMINATION OF DAILY PORTIONS.—For purposes of paragraph (1), the daily portion of the original issue discount on any debt instrument shall be determined by allocating to each day in any accrual period its ratable portion of the increase during such accrual period in the adjusted issue price of the debt instrument. For purposes of the preceding sentence, the increase in the adjusted issue price for any accrual period shall be an amount equal to the excess (if any) of—

"(A) the product of—

"(i) the adjusted issue price of the debt instrument at the beginning of such accrual period, and

"(ii) the yield to maturity (determined on the basis of compounding at the close of each accrual period), over

"(B) the sum of the amounts payable as interest on such debt instrument during such accrual period.

"(4) ADJUSTED ISSUE PRICE.—For purposes of this subsection, the adjusted issue price of any debt instrument at the beginning of any accrual period is the sum of—

"(A) the issue price of such debt instrument, plus

"(B) the adjustments under this subsection to such issue price for all periods before the first day of such accrual period.

"(5) ACCRUAL PERIOD.—Except as otherwise provided in regulations prescribed by the Secretary, the term 'accrual period' means a 1-year period (or the shorter period to maturity) beginning on the day in the calendar year which corresponds to the date of original issue of the debt instrument.

"(6) REDUCTION IN CASE OF CERTAIN SUBSEQUENT HOLDERS.—For purposes of this subsection, in the case of any purchase of a debt instrument to which this subsection applies after its original issue, the daily portion shall not include an amount (determined at the time of purchase) equal to the excess (if any) of—

"(A) the cost of such debt instrument incurred by the purchaser, over

"(B) the issue price of such debt instrument, increased by the sum of the daily portions for such debt instrument for all days before the date of purchase (computed without regard to this paragraph), divided by the number of days beginning on the date of such purchase and ending on the day before the stated maturity date.

"(b) RATABLE INCLUSION RETAINED FOR CORPORATE DEBT INSTRUMENTS ISSUED BEFORE JULY 2, 1982.—

"(1) GENERAL RULE.—There shall be included in the gross income of the holder of any debt instrument issued by a corporation after May 27, 1969, and before July 2, 1982—

"(A) the ratable monthly portion of original issue discount, multiplied by

"(B) the number of complete months (plus any fractional part of a month determined under paragraph (3)) such holder held such debt instrument during the taxable year.

"(2) DETERMINATION OF RATABLE MONTHLY PORTION.—Except as provided in paragraph (4), the ratable monthly portion of original issue discount shall equal—

"(A) the original issue discount, divided by

"(B) the number of complete months from the date of original issue to the stated maturity date of the debt instrument.

"(3) MONTH DEFINED.—For purposes of this subsection, a complete month commences with the date of original issue and the corresponding day of each succeeding calendar month (or the last day of a calendar month in which there is no corresponding day). In any case where a debt instrument is acquired on any day other than a day determined under the preceding sentence, the ratable monthly portion of original issue discount for the complete month (or partial month) in which such acquisition occurs shall be allocated between the transferor and the transferee in accordance with the number of days in such complete (or partial) month each held the debt instrument.

"(4) REDUCTION IN CASE OF CERTAIN SUBSEQUENT HOLDERS.—For purposes of this subsection, the ratable monthly portion of original issue discount shall not include an amount, determined at the time of any purchase after the original issue of the debt instrument, equal to the excess of—

"(A) the cost of such debt instrument incurred by the holder, over

"(B) the issue price of such debt instrument, increased by the portion of original discount previously includible in the gross income of any holder (computed without regard to this paragraph), divided by the number of complete months (plus any fractional part of a month) from the date of such purchase to the stated maturity date of such debt instrument.

"(c) DEFINITIONS AND SPECIAL RULES.—

"(1) PURCHASE DEFINED.—For purposes of this section, the term 'purchase' means any acquisition of a debt instrument, but only if the basis of the debt instrument is not determined in whole or in part by reference to the adjusted basis of such debt instrument in the hands of the person from whom acquired, or under section 1014(a) (relating to property acquired from a decedent).

"(2) EXCEPTIONS.—This section shall not apply to any holder—

"(A) who has purchased the debt instrument at a premium, or

"(B) which is a life insurance company to which section 811(b) applies.

"(3) BASIS ADJUSTMENTS.—The basis of any debt instrument in the hands of the holder thereof shall be increased by the amount included in his gross income pursuant to this section.

"SEC. 1273. DETERMINATION OF AMOUNT OF ORIGINAL ISSUE DISCOUNT.

"(a) General Rule.—For purposes of this subpart—

"(1) In general.—The term 'original issue discount' means the difference between—

"(A) the issue price, and

"(B) the stated redemption price at maturity.

"(2) Stated redemption price at maturity.—The term 'stated redemption price at maturity' means the amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time (other than any interest payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument).

"(3) ¼ of 1 percent de minimis rule.—If the original issue discount determined under paragraph (1) is less than—

"(A) ¼ of 1 percent of the redemption price at maturity, multiplied by

"(B) the number of complete years to maturity,

then the original issue discount shall be treated as zero.

"(b) Issue Price.—For purposes of this subpart—

"(1) PUBLICLY OFFERED DEBT INSTRUMENTS NOT ISSUED FOR PROPERTY.—In the case of any issue of debt instruments—

"(A) registered with the Securities and Exchange Commission, and

"(B) not issued for property,

the issue price is the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such debt instruments were sold.

"(2) PRIVATELY PLACED DEBT INSTRUMENTS NOT ISSUED FOR PROPERTY.—In the case of any privately placed issue of debt instruments not issued for property, the issue price of each such instrument is the price paid by the first buyer of such debt instrument.

"(3) DEBT INSTRUMENTS ISSUED FOR PROPERTY WHERE THERE IS PUBLIC TRADING.—In the case of a debt instrument which is issued for property and which—

"(A) is part of an issue a portion of which is traded on an established securities market, or

"(B) is issued for stock or securities which are traded on an established securities market,

the issue price of such debt instrument shall be the fair market value of such property.

"(4) OTHER CASES.—Except in any case—

"(A) to which paragraph (1), (2), or (3) of this subsection applies, or

"(B) to which section 1274 applies,

the issue price of a debt instrument which is issued for property shall be the stated redemption price at maturity.

"(5) PROPERTY.—In applying this subsection, the term 'property' includes services and the right to use property, but such term does not include money.

"(c) SPECIAL RULES FOR APPLYING SUBSECTION (b).—For purposes of subsection (b)—

"(1) INITIAL OFFERING PRICE; PRICE PAID BY THE FIRST BUYER.—The terms 'initial offering price' and 'price paid by the first buyer' include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof.

"(2) TREATMENT OF INVESTMENT UNITS.—In the case of any debt instrument and an option, security, or other property issued together as an investment unit—

"(A) the issue price for such unit shall be determined in accordance with the rules of this subsection and subsection (b) as if it were a debt instrument, "(B) the issue price determined for such unit shall be allocated to each element of such unit in the proportion which the fair market value of such element is of the total fair market value of all elements in such unit, and

"(C) the issue price of any debt instrument included in such unit shall be the portion of the issue price of the unit allocated to the debt instrument under subparagraph (B).

"(3) SPECIAL RULE FOR EXCHANGE OF DEBT INSTRUMENTS IN REORGANIZATIONS.—

"(A) IN GENERAL.—If—

"(i) any debt instrument is issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) for another debt instrument (hereinafter in this paragraph referred to as the 'old debt instrument'), and

"(ii) the fair market value of the old debt instrument is less than its adjusted issue price,

then, for purposes of paragraph (3) of subsection (b), the fair market value of the old debt instrument shall be treated as equal to its adjusted issue price.

"(B) DEFINITIONS.—For purposes of this paragraph—

"(i) DEBT INSTRUMENT.—The term 'debt instrument' includes an investment unit.

"(ii) ADJUSTED ISSUE PRICE.—

"(I) IN GENERAL.—The adjusted issue price of the old debt instrument is its issue price, increased by the portion of any original issue discount previously includible in the gross income of any holder (without regard to subsection (a)(6) or (b)(4) of section 1272 (or the corresponding provisions of prior law)).

"(II) SPECIAL RULE FOR APPLYING SECTION 163(e).—For purposes of section 163(e), the adjusted issue price of the old debt instrument is its issue price, increased by any original issue discount previously allowed as a deduction.

“SEC. 1274. DETERMINATION OF ISSUE PRICE IN THE CASE OF CERTAIN DEBT INSTRUMENTS ISSUED FOR PROPERTY.

“(a) IN GENERAL.—In the case of any debt instrument to which this section applies, for purposes of this subpart, the issue price shall be the lesser of—

“(1) the amount of principal payable at maturity, or

“(2) the principal amount determined under subsection (b).

“(b) DETERMINATION OF PRINCIPAL AMOUNT.—For purposes of this section—

“(1) IN GENERAL.—Except as provided in paragraph (3), the principal amount determined under this subsection of any debt instrument shall be equal to the sum of the present values of all payments due under such debt instrument.

“(2) DETERMINATION OF PRESENT VALUE.—For purposes of paragraph (1), the present value of a payment shall be determined in the manner provided by regulations prescribed by the Secretary—

“(A) as of the date of the sale or exchange, and

“(B) by using a discount rate equal to 120 percent of the applicable Federal rate, compounded semiannually.

"(3) FAIR MARKET VALUE RULE IN POTENTIALLY ABUSIVE SITUATIONS.—

"(A) IN GENERAL.—In the case of any potentially abusive situation, the principal amount determined under this subsection of any debt instrument received in exchange for property shall in no event be greater than the fair market value of such property.

"(B) POTENTIALLY ABUSIVE SITUATION DEFINED.—For purposes of subparagraph (A), the term 'potentially abusive situation' means—

"(i) a tax shelter (as defined in section 6661(b)(2)(C)(ii)), and

"(ii) any other situation which, by reason of—

"(I) recent sales transactions,

"(II) nonrecourse financing,

"(III) financing with a term in excess of the economic life of the property, or

"(IV) other circumstances,

is of a type which the Secretary specifies by regulations as having potential for tax avoidance.

"(c) DEBT INSTRUMENTS TO WHICH SECTION APPLIES.—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, this section shall apply to any debt instrument given in consideration for the sale or exchange of property if—

"(A) the stated redemption price at maturity for such instrument exceeds the principal amount of such debt instrument (as determined under subsection (b) by using a discount rate equal to 110 percent of the applicable Federal rate), or

"(B) the stated redemption price at maturity for such instrument exceeds the amount of principal payable at maturity.

"(2) EXCEPTIONS.—This section shall not apply to—

"(A) SALES FOR LESS THAN $1,000,000 OF FARMS BY INDIVIDUALS OR SMALL BUSINESSES.—

"(i) IN GENERAL.—Any debt instrument received—

"(I) by an individual, estate, or testamentary trust,

"(II) by a corporation which as of the date of the sale or exchange is a small business corporation (as defined in section 1244(c)(3)), or

"(III) by a partnership which as of the date of the sale or exchange meets requirements similar to those of section 1244(c)(3),

as consideration for the sale or exchange of a farm (within the meaning of section 6420(c)(2)) by such individual or entity.

"(ii) $1,000,000 LIMITATION.—Clause (i) shall apply only if it can be determined at the time of the sale or exchange that the sales price cannot exceed $1,000,000. For purposes of the preceding sentence, all sales and exchanges which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange.

"(B) SALES OF PRINCIPAL RESIDENCES.—Any debt instrument received by an individual as consideration for the sale or exchange of his principal residence (within the meaning of section 1034).

"(C) SALES INVOLVING TOTAL PAYMENTS OF $250,000 OR LESS.—

"(i) IN GENERAL.—Any debt instrument received as consideration for the sale or exchange of property if the sum of the following amounts does not exceed $250,000:

"(I) the aggregate amount of the payments due under such debt instrument and all other debt instruments received as consideration for the sale or exchange, and

"(II) the aggregate amount of any other consideration to be received for the sale or exchange.

"(ii) CONSIDERATION OTHER THAN DEBT INSTRUMENT TAKEN INTO ACCOUNT AT FAIR MARKET VALUE.—For purposes of clause (i), any consideration (other than a debt instrument) shall be taken into account at its fair market value.

"(iii) AGGREGATION OF TRANSACTIONS.—For purposes of this subparagraph, all sales and exchanges which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange.

"(D) DEBT INSTRUMENTS WHICH ARE PUBLICLY TRADED OR ISSUED FOR PUBLICLY TRADED PROPERTY.—Any debt instrument to which section 1273(b)(3) applies.

"(E) ANNUITIES.—Any amount the liability for which depends in whole or in part on the life expectancy of 1 or more individuals and which constitutes an amount received as an annuity to which section 72 applies.

"(F) SALES OR EXCHANGES TO WHICH SECTION 483(g) APPLIES.—Any debt instrument to the extent section 483(g) applies to such instrument.

"(G) CERTAIN SALES OF PATENTS.—In the case of any transfer described in section 1235(a) (relating to sale or exchange of patents), any amount contingent on the productivity, use, or disposition of the property transferred.

"(d) DETERMINATION OF APPLICABLE FEDERAL RATE.—For purposes of this section—

"(1) APPLICABLE FEDERAL RATE.—

"(A) IN GENERAL.—

"In the case of a debt instrument with a term of:	The applicable Federal rate is:
Not over 3 years	The Federal short-term rate.
Over 3 years but not over 9 years	The Federal mid-term rate.

—Continued

"In the case of a debt instrument with a term of:	The applicable Federal rate is:
Over 9 years	The Federal long-term rate.

"(B) DETERMINATION OF RATES.—Within 15 days after the close of—

"(i) the 6-month period ending on September 30 of any calendar year, or

"(ii) the 6-month period ending on March 31 of any calendar year,

the Secretary shall determine the Federal short-term rate, mid-term rate, and long-term rate for such 6-month period.

"(C) EFFECTIVE DATE OF DETERMINATION.—Any Federal rate determined under subparagraph (A) shall—

"(i) apply during the 6-month period beginning on January 1 of the succeeding calendar year in the case of a determination made under subparagraph (B)(i), and

"(ii) apply during the 6-month period beginning on July 1 of the calendar year in the case of a determination made under subparagraph (B)(ii).

"(D) FEDERAL RATE FOR ANY 6-MONTH PERIOD.—For purposes of this paragraph—

"(i) FEDERAL SHORT-TERM RATE.—The Federal short-term rate for any 6-month period shall be the rate determined by the Secretary to be equal to the average market yield (during such 6-month period) on outstanding marketable obligations of the United States with remaining periods to maturity of 3 years or less.

"(ii) FEDERAL MID-TERM AND LONG-TERM RATES.—The Federal mid-term rate and long-term rate shall be determined in accordance with the principles of clause (i).

"(2) RATE APPLICABLE TO ANY SALE OR EXCHANGE.—In the case of any sale or exchange, the determination of the applicable Federal rate shall be made as of the first day on which there is a binding contract in writing for the sale or exchange.

"(3) TERM OF DEBT INSTRUMENT.—In determining the term of a debt instrument for purposes of this subsection, under regulations prescribed by the Secretary, there shall be taken into account options to renew or extend.

"SEC. 1275. OTHER DEFINITIONS AND SPECIAL RULES.

"(a) DEFINITIONS.—For purposes of this subpart—

"(1) DEBT INSTRUMENT.—The term 'debt instrument' means a bond, debenture, note, or certificate or other evidence of indebtedness. Except for purposes of section 1271, such term also includes any other obligation.

"(2) ISSUE DATE.—

"(A) DEBT INSTRUMENTS REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION.—In the case of any debt instrument registered with the Securities and Exchange Commission, the term 'date of original issue' means the date on which the issue was first issued to the public.

"(B) PRIVATELY PLACED ISSUES.—In the case of any debt instrument to which section 1273(b)(2) applies, the term 'date of original issue' means the date on which the debt instrument was sold by the issuer.

"(C) OTHER DEBT INSTRUMENTS.—In the case of any debt instrument not described in subparagraph (A) or (B), the term 'date of original issue' means the date on which the debt instrument was issued in an exchange.

"(3) TAX-EXEMPT OBLIGATION.—The term 'tax-exempt obligation' means any obligation if—

"(A) the interest on such obligation is not includible in gross income under section 103, or

"(B) the interest on such obligation is exempt from tax (without regard to the identity of the holder) under any other provision of law.

"(b) TREATMENT OF CERTAIN DEFERRED PAYMENTS FOR SERVICES OR USE OF PROPERTY.—

"(1) TREATMENT OF PAYEE.—If any portion of a deferred payment to which this subsection applies is allocable to any taxable year of the payee, the taxable income of such payee for such taxable year (and subsequent taxable years) shall be determined as if—

"(A) as of the close of the taxable year, the payee received a debt instrument in exchange for the services performed (or the use of the property) during the taxable year, and

"(B) such debt instrument had original issue discount equal to the excess of—

"(i) the portion of the payment allocable to the taxable year, over

"(ii) the present value (as of the close of the taxable year) of such portion determined in accordance with the rules of section 1274(b).

"(2) TREATMENT OF PAYOR.—If any portion of a deferred payment to which this subsection applies is allocable to any taxable year of the payor, the taxable income of such payor for such taxable year (and subsequent taxable years) shall be determined as if—

"(A) as of the close of the taxable year, the payor issued a debt instrument in exchange for the services performed (or the use of the property) during the taxable year, and

"(B) such debt instrument had original issue discount equal to the excess of—

"(i) the portion of the payment allocable to the taxable year, over

"(ii) the present value (as of the close of the taxable year) of such portion determined in accordance with the rules of section 1274(b).

"(3) DEFERRED PAYMENTS TO WHICH SUBSECTION APPLIES.—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, this subsection applies to any amount to be paid for services (or the use of property) if such amount is to be paid after the close of the calendar year following the calendar year in which the services are performed (or the property is used).

"(B) SUBSECTION NOT TO APPLY TO DEFERRED PAYMENTS OF $250,000 OR LESS.—This subsection shall not apply to any amount to be paid for services (or the use of property) if the sum of the following amounts does not exceed $250,000—

"(i) the aggregate amount of payments due under debt instruments received as consideration for such services (or use of property), and

"(ii) the aggregate amount of any other consideration to be received for such services (or use of property).

For purposes of the preceding sentence, rules similar to the rules of clauses (ii) and (iii) of section 1274(c)(2)(C) shall apply.

"(C) COORDINATION WITH SECTION 1273(b)(3).—This subsection shall not apply to any debt instrument to which section 1273(b)(3) applies.

"(D) PAYMENTS TO WHICH OTHER SECTIONS APPLY.—This subsection shall not apply to any payment if section 83, 267, 404, 404A, or 706(a) applies to such payment. Sections 83, 267, 404, 404A, and 706(a) shall be applied before the application of this subsection.

"(4) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of the subsection—

"(A) ALLOCATION OF DEFERRED PAYMENT.—The portion of a deferred payment to which this subsection applies allocable to any taxable year shall be determined under the accrual method of accounting.

"(B) PAYEE.—The term 'payee' means the person to whom the deferred payment is to be made.

"(C) PAYOR.—The term 'payor' means the person required to make the deferred payment.

"(c) INFORMATION REQUIREMENTS.—

"(1) INFORMATION REQUIRED TO BE SET FORTH ON INSTRUMENT.—

"(A) IN GENERAL.—In the case of any debt instrument having original issue discount, the Secretary may by regulations require that—

"(i) the amount of the original issue discount, and

"(ii) the issue date,

be set forth on such instrument.

"(B) SPECIAL RULE FOR PRIVATELY PLACED INSTRUMENTS.—In the case of any privately placed issue of debt instruments, the regulations prescribed under subparagraph (A) shall not require the information to be set forth on the debt instrument before any disposition of such instrument by the first buyer.

"(2) INFORMATION REQUIRED TO BE SUBMITTED TO SECRETARY.—In the case of any issue of debt instruments having original issue discount and registered with the Securities and Exchange Commission, the issuer shall (at such time and in such manner as the Secretary shall by regulation prescribe) furnish the Secretary the following information:

"(A) The amount of the original issue discount.

"(B) The issue date.

"(C) Such other information with respect to the issue as the Secretary may by regulations require.

For purposes of the preceding sentence, any person who makes a public offering of stripped bonds (or stripped coupons) shall be treated as the issuer of a debt instrument having original issue discount and registered with the Securities and Exchange Commission.

"(3) EXCEPTIONS.—This subsection shall not apply to any obligation referred to in section 1272(a)(2).

"(4) CROSS REFERENCE.—

"For civil penalty for failure to meet requirements of this subsection, see section 6706.

"(d) REGULATION AUTHORITY.—The Secretary may prescribe regulations providing that where, by reason of varying rates of interest, put or call options, indefinite maturities, contingent payments, or other circumstances, the tax treatment under this subpart (or section 163(e)) does not carry out the purposes of this subpart (or section 163(e)), such treatment will be modified to the extent necessary to carry out the purposes of this subpart (or section 163(e)).

"Subpart B—Market Discount on Bonds

"Sec. 1276. Disposition gain representing accrued market discount treated as ordinary income.
"Sec. 1277. Deferral of interest deduction allocable to accrued market discount.
"Sec. 1278. Definitions and special rules.

"SEC. 1276. DISPOSITION GAIN REPRESENTING ACCRUED MARKET DISCOUNT TREATED AS ORDINARY INCOME.

"(a) ORDINARY INCOME.—

"(1) IN GENERAL.—Except as otherwise provided in this section, gain on the disposition of any market discount bond shall be treated as ordinary income to the extent it does not exceed the accrued market discount on such bond. Such gain shall be treated as interest and recognized notwithstanding any other provision of this subtitle.

"(2) DISPOSITIONS OTHER THAN SALES, ETC.—For purposes of paragraph (1), a person disposing of any market discount bond in any transaction other than a sale, exchange, or involuntary conversion shall be treated as realizing an amount equal to the fair market value of the bond.

"(b) ACCRUED MARKET DISCOUNT.—For purposes of this section—

"(1) RATABLE ACCRUAL.—Except as otherwise provided in this subsection or subsection (c), the accrued market discount on any bond shall be an amount which bears the same ratio to the market discount on such bond as—

"(A) the number of days which the taxpayer held the bond, bears to

"(B) the number of days after the date the taxpayer acquired the bond and up to (and including) the date of its maturity.

"(2) ELECTION OF ACCRUAL ON BASIS OF CONSTANT INTEREST RATE (IN LIEU OF RATABLE ACCRUAL).—

"(A) IN GENERAL.—At the election of the taxpayer with respect to any bond, the accrued market discount on such bond shall be the aggregate amount which would have been includible in the gross income of the taxpayer under section 1272(a) with respect to such bond for all periods during which the bond was held by the taxpayer if such bond had been—

"(i) originally issued on the date on which such bond was acquired by the taxpayer,

"(ii) for an issue price equal to the adjusted basis of the taxpayer in such bond immediately after its acquisition.

"(B) COORDINATION WHERE BOND HAS ORIGINAL ISSUE DISCOUNT.—In the case of any bond having original issue discount, for purposes of applying subparagraph (A)—

"(i) the stated redemption price of such bond at maturity shall be treated as equal to its revised issue price, and "(ii) the determination of the portion of the original issue discount which would be includible in the gross income of the taxpayer under section 1272(a) shall be made under regulations prescribed by the Secretary.

"(C) ELECTION IRREVOCABLE.—An election under subparagraph (A), once made with respect to any bond, shall be irrevocable.

"(c) TREATMENT OF NONRECOGNITION TRANSACTIONS.—Under regulations prescribed by the Secretary—

"(1) TRANSFERRED BASIS PROPERTY.—If a market discount bond is transferred in a nonrecognition transaction and such bond is transferred basis property in the hands of the transferee, for purposes of determining the amount of the accrued market discount with respect to the transferee—

"(A) the transferee shall be treated as having acquired the bond on the date on which it was acquired by the transferor for an amount equal to the adjusted basis of the transferor, and

"(B) proper adjustments shall be made for gain recognized by the transferor on such transfer (and for any original issue discount or market discount included in the gross income of the transferor).

"(2) EXCHANGED BASIS PROPERTY.—If any market discount bond is disposed of by the taxpayer in a nonrecognition transaction and paragraph (1) does not apply to such transaction—

"(A) any exchanged basis property received by the taxpayer in such transaction (if not otherwise a market discount bond) shall be treated as a market discount bond, and

"(B) the amount of the accrued market discount with respect to such exchanged basis property shall include any accrued market discount determined with respect to the property disposed of to the extent not theretofore treated as ordinary income under subsection (a).

"(d) SPECIAL RULES.—Under regulations prescribed by the Secretary—

"(1) rules similar to the rules of subsection (b) of section 1245 shall apply for purposes of this section; except that—

"(A) paragraph (1) of such subsection shall not apply, and

"(B) an exchange qualifying under section 354(a), 355(a), or 356(a) (determined without regard to subsection (a) of this section) shall be treated as an exchange described in paragraph (3) of such subsection, and

"(2) appropriate adjustments shall be made to the basis of any property to reflect gain recognized under subsection (a).

"(e) SECTION NOT TO APPLY TO MARKET DISCOUNT BONDS ISSUED BEFORE DATE OF ENACTMENT OF SECTION.—This section shall not apply to any market discount bond issued before the date of the enactment of this section.

"SEC. 1277. DEFERRAL OF INTEREST DEDUCTION ALLOCABLE TO ACCRUED MARKET DISCOUNT.

"(a) GENERAL RULE.—Except as otherwise provided in this section, the net direct interest expense with respect to any market discount bond shall be allowed as a deduction for the taxable year only to the extent that such expense exceeds the portion of the market discount allocable to the days during the taxable year on which such bond was held by the taxpayer (as determined under the rules of section 1276(b)).

"(b) DISALLOWED DEDUCTION ALLOWED FOR YEAR OF DISPOSITION.—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, the amount of the disallowed interest expense with respect to any market discount bond shall be treated as interest paid or accrued by the taxpayer in the taxable year in which such bond is disposed of.

"(2) NONRECOGNITION TRANSACTIONS.—If any market discount bond is disposed of in a nonrecognition transaction (as defined in section 7701(a)(45))—

"(A) the disallowed interest expense with respect to such bond shall be treated as interest paid or accrued in the year of disposition only to the extent of the amount of gain recognized on such disposition, and

"(B) the disallowed interest expense with respect to such property (to the extent not so treated) shall be treated as disallowed interest expense—

"(i) in the case of a transaction described in section 1276(c)(1), of the transferee with respect to the transferred basis property, or

"(ii) in the case of a transaction described in section 1276(c)(2), with respect to the exchanged basis property.

"(3) DISALLOWED INTEREST EXPENSE.—For purposes of this subsection, the term 'disallowed interest expense' means the aggregate amount disallowed under subsection (a) with respect to the market discount bond.

"(c) Net Direct Interest Expense.—For purposes of this section, the term 'net direct interest expense' means, with respect to any market discount bond, the excess (if any) of—

"(1) the amount of interest paid or accrued during the taxable year on indebtedness which is incurred or continued to purchase or carry such bond, over

"(2) the aggregate amount of interest (including original issue discount) includible in gross income for the taxable year with respect to such bond.

"SEC. 1278. DEFINITIONS AND SPECIAL RULES.

"(a) In General.—For purposes of this part—

"(1) Market discount bond.—

"(A) In general.—Except as provided in subparagraph (B), the term 'market discount bond' means any bond having market discount.

"(B) Exceptions.—The term 'market discount bond' shall not include—

"(i) Short-term obligations.—Any obligation with a fixed maturity date not exceeding 1 year from the date of issue.

"(ii) TAX-EXEMPT OBLIGATIONS.—Any tax-exempt obligation (as defined in section 1275(a)(3)).

"(iii) UNITED STATES SAVINGS BONDS.—Any United States savings bond.

"(2) MARKET DISCOUNT.—

"(A) IN GENERAL.—The term 'market discount' means the excess (if any) of—

"(i) the stated redemption price of the bond at maturity, over

"(ii) the adjusted basis of such bond immediately after its acquisition by the taxpayer.

"(B) COORDINATION WHERE BOND HAS ORIGINAL ISSUE DISCOUNT.—In the case of any bond having original issue discount, for purposes of subparagraph (A), the stated redemption price of such bond at maturity shall be treated as equal to its revised issue price.

"(C) DE MINIMIS RULE.—If the market discount is less than ¼ of 1 percent of the stated redemption price of the bond at maturity multiplied by the number of complete years to maturity (after the taxpayer acquired the bond), then the market discount shall be considered to be zero.

"(3) BOND.—The term 'bond' means any bond, debenture, note, certificate, or other evidence of indebtedness.

"(4) REVISED ISSUE PRICE.—The term 'revised issue price' means of the sum of—

"(A) the issue price of the bond, and

"(B) the aggregate amount of the original issue discount includible in the gross income of all holders for periods before the acquisition of the bond by the taxpayer (determined without regard to section 1272(a)(6)).

"(5) ORIGINAL ISSUE DISCOUNT, ETC.—The terms 'original issue discount', 'stated redemption price at maturity', and 'issue price' have the respective meanings given such terms by subpart A of this part.

"(b) ELECTION TO INCLUDE MARKET DISCOUNT CURRENTLY.—

"(1) IN GENERAL.—If the taxpayer makes an election under this subsection—

"(A) sections 1276 and 1277 shall not apply, and

"(B) market discount on any market discount bond shall be included in the gross income of the taxpayer for the taxable years to which it is attributable (as determined under the rules of subsection (b) of section 1276).

"(2) SCOPE OF ELECTION.—An election under this subsection shall apply to all market discount bonds acquired by the taxpayer on or after the 1st day of the 1st taxable year to which such election applies.

"(3) PERIOD TO WHICH ELECTION APPLIES.—An election under this subsection shall apply to the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to the revocation of such election.

"(c) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subpart.

"Subpart C—Discount on Short-Term Obligations

"Sec. 1281. Current inclusion in income of discount on certain short-term obligations.
"Sec. 1282. Deferral of interest deduction allocable to accrued discount.
"Sec. 1283. Definitions and special rules.

"SEC. 1281. CURRENT INCLUSION IN INCOME OF DISCOUNT ON CERTAIN SHORT-TERM OBLIGATIONS.

"(a) IN GENERAL.—In the case of any short-term obligation to which this section applies, for purposes of this title, there shall be included in the gross income of the holder an amount equal to the sum of the daily portions of the acquisition discount for each day during the taxable year on which such holder held such bond.

"(b) SHORT-TERM OBLIGATIONS TO WHICH SECTION APPLIES.—This section shall apply to any short-term obligations which—

"(1) is held by a taxpayer using an accrual method of accounting,

"(2) is held by a bank (as defined in section 581),

"(3) is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, or

"(4) is identified by the taxpayer under section 1256(e)(2) as being part of a hedging transaction.

"(c) CROSS REFERENCE.—

"For special rules limiting the application of this section to original issue discount in the case of nongovernmental obligations, see section 1283(c).

"SEC. 1282. DEFERRAL OF INTEREST DEDUCTION ALLOCABLE TO ACCRUED DISCOUNT.

"(a) GENERAL RULE.—Except as otherwise provided in this section, the net direct interest expense with respect to any short-term obligation shall be allowed as a deduction for the taxable year only to the extent that such expense exceeds the sum of the daily portions of the acquisition discount for each day during the taxable year on which the taxpayer held such obligation.

"(b) SECTION NOT TO APPLY TO OBLIGATIONS TO WHICH SECTION 1281 APPLIES.—

"(1) IN GENERAL.—This section shall not apply to any short-term obligation to which section 1281 applies.

"(2) ELECTION TO HAVE SECTION 1281 APPLY TO ALL OBLIGATIONS.—

"(A) IN GENERAL.—A taxpayer may make an election under this paragraph to have section 1281 apply to all short-term obligations acquired by the taxpayer on or after the 1st day of the 1st taxable year to which such election applies.

"(B) PERIOD TO WHICH ELECTION APPLIES.—An election under this paragraph shall apply to the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to the revocation of such election.

"(c) CERTAIN RULES MADE APPLICABLE.—Rules similar to the rules of subsections (b) and (c) of section 1277 shall apply for purposes of this section.

"(d) CROSS REFERENCE.—

"For special rules limiting the application of this section to original issue discount in the case of nongovernmental obligations, see section 1283(c).

"SEC. 1283. DEFINITIONS AND SPECIAL RULES.

"(a) DEFINITIONS.—For purposes of this subpart—

"(1) SHORT-TERM OBLIGATION.—

"(A) In general.—Except as provided in subparagraph (B), the term 'short-term obligation' means any bond, debenture, note, certificate, or other evidence of indebtedness which has a fixed maturity day not exceeding 1 year from the date of issue.

"(B) Exceptions for tax-exempt obligations.—The term 'short-term obligation' shall not include any tax-exempt obligation (as defined in section 1275(a)(3)).

"(2) Acquisition discount.—The term 'acquisition discount' means the excess of—

"(A) the stated redemption price at maturity (as defined in section 1273), over

"(B) the taxpayer's basis for the obligation.

"(b) Daily Portion.—For purposes of this subpart—

"(1) Ratable accrual.—Except as otherwise provided in this subsection, the daily portion of the acquisition discount is an amount equal to—

"(A) the amount of such discount, divided by

"(B) the number of days after the day on which the taxpayer acquired the obligation and up to (and including) the day of its maturity.

"(2) Election of accrual on basis of constant interest rate (in lieu of ratable accrual).—

"(A) In general.—At the election of the taxpayer with respect to any obligation, the daily portion of the acquisition discount for any day is the portion of the acquisition discount accruing on such day determined (under regulations prescribed by the Secretary) on the basis of—

"(i) the taxpayer's yield to maturity based on the taxpayer's cost of acquiring the obligation, and

"(ii) compounding daily.

"(B) Election irrevocable.—An election under subparagraph (A), once made with respect to any obligation, shall be irrevocable.

"(c) Special Rules for Nongovernmental Obligations.—In the case of any short-term obligations which is not a short-term Government obligation (as defined in section 1271(a)(3)(B))—

"(1) sections 1281 and 1282 shall be applied by taking into account original issue discount in lieu of acquisition discount, and

"(2) appropriate adjustments shall be made in the application of subsection (b) of this section.

"(d) OTHER SPECIAL RULES.—

"(1) BASIS ADJUSTMENTS.—The basis of any short-term obligation in the hands of the holder thereof shall be increased by the amount included in his gross income pursuant to section 1281.

"(2) DOUBLE INCLUSION IN INCOME NOT REQUIRED.—Section 1281 shall not require the inclusion of any amount previously includible in gross income.

"(3) COORDINATION WITH OTHER PROVISIONS.—Section 454(b) and section 1271(a)(3) shall not apply to any short-term obligation to which section 1281 applies.

"Subpart D—Miscellaneous Provisions

"Sec. 1286. Tax treatment of stripped bonds.
"Sec. 1287. Denial of capital gain treatment for gains on certain obligations not in registered form.
"Sec. 1288. Treatment of original issue discount on tax-exempt obligations.

"SEC. 1286. TAX TREATMENT OF STRIPPED BONDS.

"(a) INCLUSION IN INCOME AS IF BOND AND COUPONS WERE ORIGINAL ISSUE DISCOUNT BONDS.—If any person purchases after July 1, 1982, a stripped bond or a stripped coupon, then such bond or coupon while held by such purchaser (or by any other person whose basis is determined by reference to the basis in the hands of such purchaser) shall be treated for purposes of section 1272(a) as a bond originally issued on the purchase date and having an original issue discount equal to the excess (if any) of—

"(1) the stated redemption price at maturity (or, in the case of coupon, the amount payable on the due date of such coupon), over

"(2) such bond's or coupon's ratable share of the purchase price.

For purposes of paragraph (2), ratable shares shall be determined on the basis of their respective fair market values on the date of purchase.

"(b) TAX TREATMENT OF PERSON STRIPPING BOND.—For purposes of this subtitle, if any person strips 1 or more coupons from a bond and after July 1, 1982, disposes of the bond or such coupon—

"(1) such person shall include in gross income an amount equal to the interest accrued on such bond before the time that such coupon or bond was disposed of (to the extent such interest has not theretofore been included in such person's gross income),

"(2) the basis of the bond and coupons shall be increased by the amount of the accrued interest described in paragraph (1),

"(3) the basis of the bond and coupons immediately before the disposition (as adjusted pursuant to paragraph (2)) shall be allocated among the items retained by such person and the items disposed of by such person on the basis of their respective fair market values, and

"(4) for purposes of subsection (a), such person shall be treated as having purchased on the date of such disposition each such item which he retains for an amount equal to the basis allocated to such item under paragraph (3).

A rule similar to the rule of paragraph (4) shall apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis of the person described in the preceding sentence.

"(c) RETENTION OF EXISTING LAW FOR STRIPPED BONDS PURCHASED BEFORE JULY 2, 1982.—If a bond issued at any time with interest coupons—

"(1) is purchased after August 16, 1954, and before January 1, 1958, and the purchaser does not receive all the coupons which first become payable more than 12 months after the date of the purchase, or

"(2) is purchased after December 31, 1957, and before July 2, 1982, and the purchaser does not receive all the coupons which first become payable after the date of the purchase,

then the gain on the sale or other disposition of such bond by such purchaser (or by a person whose basis is determined by reference to the basis in the hands of such purchaser) shall be considered as ordinary income to the extent that the fair market value (determined as of the time of the purchase) of the bond with coupons attached exceeds the purchase price. If this subsection and section 1271(a)(2)(A) apply with respect to gain realized on the sale or exchange of any evidence of indebtedness, then section 1271(a)(2)(A) shall apply with respect to that part of the gain to which this subsection does not apply.

"(d) SPECIAL RULES FOR TAX-EXEMPT OBLIGATIONS.—In the case of any tax-exempt obligation (as defined in section 1275(a)(3))—

"(1) subsections (a) and (b)(1) shall not apply,

"(2) the rules of subsection (b)(4) shall apply for purposes of subsection (c), and

"(3) subsection (c) shall be applied without regard to the requirement that the bond be purchased before July 2, 1982.

"(e) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) BOND.—The term 'bond' means a bond, debenture, note, or certificate or other evidence of indebtedness.

"(2) STRIPPED BOND.—The term 'stripped bond' means a bond issued at any time with interest coupons where there is a separation in ownership between the bond and any coupon which has not yet become payable.

"(3) STRIPPED COUPON.—The term 'stripped coupon' means any coupon relating to a stripped bond.

"(4) STATED REDEMPTION PRICE AT MATURITY.—The term 'stated redemption price at maturity' has the meaning given such term by section 1273(a)(2).

"(5) COUPON.—The term 'coupon' includes any right to receive interest on a bond (whether or not evidenced by a coupon). This paragraph shall apply for purposes of subsection (c) only in the case of purchases after July 1, 1982.

"(f) REGULATION AUTHORITY.—The Secretary may prescribe regulations providing that where, by reason of varying rates of interest, put or call options, or other circumstances, the tax treatment under this section does not accurately reflect the income of the holder of a stripped coupon or stripped bond, or of the person disposing of such bond or coupon, as the case may be, for any period, such treatment shall be modified to require that the proper amount of income be included for such period.

"SEC. 1287. DENIAL OF CAPITAL GAIN TREATMENT FOR GAINS ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.

"(a) In General.—If any registration-required obligation is not in registered form, any gain on the sale or other disposition of such obligation shall be treated as ordinary income (unless the issuance of such obligation was subject to tax under section 4701).

"(b) Definitions.—For purposes of subsection (a)—

"(1) Registration-required obligation.—The term 'registration-required obligation' has the meaning given to such term by section 163(f)(2) except that clause (iv) of subparagraph (A), and subparagraph (B), of such section shall not apply.

"(2) Registered form.—The term 'registered form' has the same meaning as when used in section 163(f).

"SEC. 1288. TREATMENT OF ORIGINAL ISSUE DISCOUNT ON TAX-EXEMPT OBLIGATIONS.

"(a) General Rule.—For purposes of this title, original issue discount on any tax-exempt obligation shall be treated as accruing—

"(1) for purposes of section 163, in the manner provided by section 1272(a) (determined without regard to paragraph (6) thereof), and

"(2) for purposes of determining the adjusted basis of the holder, in the manner provided by section 1272(a) (determined with regard to paragraph (6) thereof).

"(b) Definitions.—For purposes of this section—

"(1) Original issue discount.—The term 'original issue discount' has the meaning given to such term by section 1273(a) without regard to paragraph (3) thereof. In applying section 1273(b)(1) for purposes of the preceding sentence, an issue shall be treated as registered with the Securities and Exchange Commission if it is a publicly offered tax-exempt obligation.

"(2) Tax-exempt obligation.—The term 'tax-exempt obligation' has the meaning given to such term by section 1275(a)(3)."

(b) Amendment of Section 483.—Section 483 (relating to interest on certain deferred payments) is amended to read as follows:

"SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

"(a) Amount Constituting Interest.—For purposes of this title, in the case of any payment—

"(1) under any contract for the sale or exchange of any property, and

"(2) to which this section applies,

there shall be treated as interest that portion of the total unstated interest under such contract which, as determined in a manner consistent with the method of computing interest under section 1272(a), is properly allocable to such payment.

"(b) TOTAL UNSTATED INTEREST.—For purposes of this section, the term 'total unstated interest' means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

"(1) the sum of the payments to which this section applies which are due under the contract, over

"(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of the preceding sentence, the present value of a payment shall be determined under the rules of section 1274(b)(2) using a discount rate equal to 120 percent of the applicable Federal rate determined under section 1274(d).

"(c) PAYMENTS TO WHICH SUBSECTION (a) APPLIES.—

"(1) IN GENERAL.—Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

"(A) under which some or all of the payments are due more than 1 year after the date of such sale or exchange, and

"(B) under which, using a discount rate equal to 110 percent of the applicable Federal rate determined under section 1274(d), there is total unstated interest.

"(2) TREATMENT OF OTHER DEBT INSTRUMENTS.—For purposes of this section, a debt instrument of the purchaser which is given in consideration for the sale or exchange of property shall not be treated as a payment, and any payment due under such debt instrument shall be treated as due under the contract for the sale or exchange.

"(3) DEBT INSTRUMENT DEFINED.—For purposes of this subsection, the term 'debt instrument' has the meaning given such term by section 1275(a)(1).

"(d) PAYMENTS INDEFINITE AS TO TIME, LIABILITY, OR AMOUNT.—In the case of a contract for the sale or exchange of property under which the liability for, or the amount or due date of, any portion of a payment cannot be determined at the time of the sale or exchange, this section shall be separately applied to such portion as if it (and any amount of interest attributable to such portion) were the only payments due under the contract; and such determinations of liability, amount, and due date shall be made at the time payment of such portion is made.

"(e) CHANGE IN TERMS OF CONTRACT.—If the liability for, or the amount or due date of, any payment (including interest) under a contract for the sale or exchange of property is changed, the 'total unstated interest' under the contract shall be recomputed and allocated (with adjustment for prior interest (including unstated interest) payments) under regulations prescribed by the Secretary.

"(f) EXCEPTIONS AND LIMITATIONS.—

"(1) COORDINATION WITH ORIGINAL ISSUE DISCOUNT RULES.—This section shall not apply to any debt instrument to which section 1272 applies.

"(2) SALES PRICES OF $3,000 OR LESS.—This section shall not apply to any payment on account of the sale or exchange of property if it can be detemined at the time of such sale or exchange that the sales price cannot exceed $3,000.

"(3) CARRYING CHARGES.—In the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property shall be made without regard to this section if any such amounts are treated under section 163(b) as if they included interest.

"(4) CERTAIN SALES OF PATENTS.—In the case of any transfer described in section 1235(a) (relating to sale or exchange of patents), this section shall not apply to any amount contingent on the productivity, use, or disposition of the property transferred.

"(5) ANNUITIES.—This section shall not apply to any amount the liability for which depends in whole or in part on the life expectancy of 1 or more individuals and which constitutes an amount received as an annuity to which section 72 applies.

"(g) MAXIMUM RATE OF INTEREST ON CERTAIN TRANSFERS OF LAND BETWEEN RELATED PARTIES.—

"(1) IN GENERAL.—In the case of any qualified sale, the discount rate used in determining the total unstated interest rate under subsection (b) shall not exceed 7 percent, compounded semiannually.

"(2) QUALIFIED SALE.—For purposes of this subsection, the term 'qualified sale' means any sale or exchange of land by an individual to a member of such individual's family (within the meaning of section 267(c)(4)).

"(3) $500,000 LIMITATION.—Paragraph (1) shall not apply to any qualified sale between individuals made during any calendar year to the extent that the sales price for such sale (when added to the aggregate sales price for prior qualified sales between such individuals during the calendar year) exceeds $500,000.

"(4) NONRESIDENT ALIEN INDIVIDUALS.—Paragraph (1) shall not apply to any sale or exchange if any party to such sale or exchange is a nonresident alien individual."

(c) PENALTY FOR FAILURE TO MEET INFORMATION REQUIREMENTS.—

(1) IN GENERAL.—Subchapter B of chapter 68 (relating to assessable penalties) is amended by adding at the end thereof the following new section:

"SEC. 6706. ORIGINAL ISSUE DISCOUNT INFORMATION REQUIREMENTS.

"(a) FAILURE TO SHOW INFORMATION ON DEBT INSTRUMENT.—In the case of a failure to set forth on a debt instrument the information required to be set forth on such instrument under section 1275(c)(1), unless it is shown that such failure is due to reasonable cause and not to willful neglect, the issuer shall pay a penalty of $50 for each instrument with respect to which such a failure exists.

"(b) FAILURE TO FURNISH INFORMATION TO SECRETARY.—Any issuer who fails to furnish information required under section 1275(c)(2) with respect to any issue of debt instruments on the date prescribed therefor (determined with regard to any extension of time for filing) shall pay a penalty equal to 1 percent of the aggregate issue price of such issue, unless it is shown that such failure is due to reasonable cause and not willful neglect.

"(c) DEFICIENCY PROCEDURES NOT TO APPLY.—Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) shall not apply in respect of the assessment or collection of any penalty imposed by this section."

(2) CLERICAL AMENDMENT.—The table of sections for subchapter B of chapter 68 is amended by adding at the end thereof the following new item:

"Sec. 6706. Original issue discount information requirements."

SEC. 42. TECHNICAL AND CONFORMING AMENDMENTS RELATED TO ORIGINAL ISSUE DISCOUNT CHANGES.

(a) GENERAL RULE.—

(1) Sections 1232, 1232A, and 1232B are hereby repealed.

(2) Clause (i) of section 103A(i)(2)(C) (defining yield on the issue) is amended by striking out "section 1232(b)(2)" and inserting in lieu thereof "sections 1273(b) and 1274".

(3) Subsection (e) of section 163 (relating to original issue discount) is amended to read as follows:

"(e) ORIGINAL ISSUE DISCOUNT.—

"(1) IN GENERAL.—In the case of any debt instrument issued after July 1, 1982, the portion of the original issue discount with respect to such debt instrument which is allowable as a deduction to the issuer for any taxable year shall be equal to the aggregate daily portions of the original issue discount for days during such taxable year.

"(2) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

"(A) DEBT INSTRUMENT.—The term 'debt instrument' has the meaning given such term by section 1275(a)(1).

"(B) DAILY PORTIONS.—The daily portion of the original issue discount for any day shall be determined under section 1272(a) (without regard to paragraph (6) thereof and without regard to section 1273(a)(3)).

"(3) CROSS REFERENCE.—

"For provision relating to deduction of original issue discount on tax-exempt obligation, see section 1288."

(4) Paragraph (3) of section 165(j) (relating to denial of deductions for losses on certain obligations not in registered form) is amended by striking out "subsection (d) of section 1232" and inserting in lieu thereof "section 1282".

(5) Paragraph (1) of section 249(b) (relating to limitation on deduction of bond premium on repurchase) is amended by striking out "section 1232(b)"

and inserting in lieu thereof "sections 1273(b) and 1274".

(6) Clause (ii) of section 263(g)(2)(B) (defining interest and carrying charges) is amended by striking out "section 1232(a)(3)(A)" and inserting in lieu thereof "section 1271(a)(3)(A)".

(7) Paragraph (1) of section 405(d) (relating to taxability of beneficiary of qualified bond purchase plan) is amended by striking out "section 1232 (relating to bonds and other evidences of indebtedness)" and inserting in lieu thereof "section 1271 (relating to treatment of amounts received on retirement or sale or exchange of debt instruments)".

(8) Paragraph (1) of section 409(b) (relating to income tax treatment of bonds) is amended by striking out "section 1232 (relating to bonds and other evidences of indebtedness)" and inserting in lieu thereof "section 1271 (relating to treatment of amounts received on retirement or sale or exchange of debt instruments)".

(9) Paragraph (3) of section 811(b) (relating to amortization of premium and accrual of discount), as amended by this Act, is amended by striking out "section 1232(b)" and inserting in lieu thereof "section 1273".

(10) Subsection (b) of section 1037 (relating to application of section 1232) is amended—

(A) by striking out "section 1232(a)(2)(B)" in paragraph (1) and inserting in lieu thereof "section 1271(c)(2)",

(B) by striking out "section 1232" in paragraphs (1) and (2) and inserting in lieu thereof "subpart A of part V of subchapter P", and

(C) by striking out "SECTION 1232" in the subsection heading and inserting in lieu thereof "ORIGINAL ISSUE DISCOUNT RULES".

(11) Subsection (h) of section 1351 (relating to special rule for evidences of indebtedness) is amended by striking out "section 1232(a)(2)" and inserting in lieu thereof "section 1273(a)".

(12) Paragraph (6) of section 6049(d) (relating to treatment of original issue discount) is amended—

(A) by striking out "section 1232A" each place it appears in subparagraph (A) and inserting in lieu thereof "section 1272", and

(B) by striking out "section 1232(b)(1)" and inserting in lieu thereof "section 1273(a)".

(b) CLERICAL AMEMDMENTS.—

(1) The table of parts for subchapter P of chapter 1 is amended by adding at the end thereof the following new item:

"PART V. Special rules for bonds and other debt instruments."

(2) The table of sections for part IV of subchapter P of chapter 1 is amended by striking out the items relating to sections 1232, 1232A, and 1232B.

SEC. 43. TECHNICAL AND CONFORMING AMENDMENTS RELATED TO TREATMENT OF MARKET DISCOUNT AND ACQUISITION DISCOUNT.

(a) DEFINITION OF SUBSTITUTED BASIS PROPERTY; ETC.—

(1) IN GENERAL.—Section 7701(a) (relating to definitions) is amended by adding at the end thereof the following new paragraphs:

"(42) SUBSTITUTED BASIS PROPERTY.—The term 'substituted basis property' means property which is—

"(A) transferred basis property, or

"(B) exchanged basis property.

"(43) TRANSFERRED BASIS PROPERTY.—The term 'transferred basis property' means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.

"(44) EXCHANGED BASIS PROPERTY.—The term 'exchanged basis property' means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.

"(45) NONRECOGNITION TRANSACTION.—The term 'nonrecognition transaction' means any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A."

(2) TECHNICAL AMENDMENT.—Subsection (b) of section 1016 is amended by striking out the last sentence.

(b) ELECTIONS MADE IN MANNER PRESCRIBED BY SECRETARY.—Section 7805 (relating to rules and regulations) is amended by adding at the end thereof the following new subsection:

"(d) MANNER OF MAKING ELECTIONS PRESCRIBED BY SECRETARY.—Except to the extent otherwise provided by this title, any election under this title shall be made at such time and in such manner as the Secretary shall by regulations or forms prescribe."

(c) OTHER TECHNICAL AMENDMENTS.—

(1) Paragraph (12) of section 341(e) (related to nonapplication of section 1254(a)) is amended by striking out "and 1254(a)" and inserting in lieu thereof "1254(a), and 1276(a)".

(2) Paragraph (2) of section 453B(d) (relating to liquidations to which section 337 applies) is amended by striking out "or 1254(a)" and inserting in lieu thereof "1254(a), or 1276(a)".

(3) Subsection (c) of section 751 (defining unrealized receivables) is amended—

(A) by striking out "and an oil, gas, or geothermal property (described in section 1254) and inserting in lieu thereof "an oil, gas, or geothermal property (described in section 1254), and a market discount bond (as defined in section 1278)", and

(B) by striking out "or 1254(a)" and inserting in lieu thereof "1254(a), or 1276(a)".

SEC. 44. EFFECTIVE DATES.

(a) GENERAL RULE.—Except as otherwise provided in this section, the amendments made by this subtitle shall apply to taxable years ending after the date of the enactment of this Act.

(b) TREATMENT OF DEBT INSTRUMENTS RECEIVED IN EXCHANGE FOR PROPERTY.—

(1) IN GENERAL.—

(A) Except as otherwise provided in this subsection, sections 1274 and 1275(b) of the Internal Revenue Code of 1954 (as added by this subtitle) and the amendment made by section 41(b) (relating to amendment of section 483) shall apply to sales or exchanges after December 31, 1984.

(B) Sections 1274 and 1275(b) of such Code and the amendment made by section 41(b) shall not apply to any sale or exchange pursuant to a written contract which was binding on March 1, 1984, and at all times thereafter before the sale or exchange.

(2) REVISION OF SECTION 482 REGULATIONS.—Not later than 180 days after the date of the enactment of this Act, the Secretary of the Treasury or his delegate shall modify the safe harbor interest rates applicable under the regulations prescribed under section 482 of the Internal Revenue Code of 1954 so that such rates are consistent with the rates applicable

under section 483 of such Code by reason of the amendments made by section 41.

(3) CLARIFICATION OF INTEREST ACCRUAL; FAIR MARKET VALUE RULE IN CASE OF POTENTIALLY ABUSIVE SITUATIONS.—

(A) IN GENERAL.—In the case of any sale or exchange after March 1, 1984, and before January 1, 1985—

(i) nothing in section 483 of the Internal Revenue Code of 1954 shall permit any interest to be deductible before the period to which such interest is properly allocable, and

(ii) such section 483 shall be treated as including provisions similar to the provisions of section 1274(b)(3) of such Code (as added by this subtitle).

(B) EXCEPTION FOR BINDING CONTRACTS.—Subparagraph (A) shall not apply to any sale or exchange pursuant to a written contract which was binding on March 1, 1984, and at all times thereafter before the sale or exchange.

(C) INTEREST ACCRUAL RULE NOT TO APPLY WHERE SUBSTANTIALLY EQUAL ANNUAL PAYMENTS.—Clause (i) of subparagraph (A) shall not apply to any debt instrument with substantially equal annual payments.

(c) MARKET DISCOUNT RULES.—

(1) ORDINARY INCOME TREATMENT.—Section 1276 of the Internal Revenue Code of 1954 (as added by this subtitle) shall apply to obligations issued after the date of the enactment of this Act in taxable years ending after such date.

(2) INTEREST DEFERRAL RULES.—Section 1277 of such Code (as added by this subtitle) shall apply to obligations acquired after the date of the enactment of this Act in taxable years ending after such date.

(d) RULES RELATING TO DISCOUNT ON SHORT-TERM OBLIGATIONS.—Subpart C of part V of subchapter P of chapter 1 of such Code (as added by this subtitle) shall apply to obligations acquired after the date of the enactment of this Act.

(e) 10-YEAR SPREAD OF ADJUSTMENTS REQUIRED BY REASON OF ACCRUAL OF DISCOUNT ON CERTAIN SHORT-TERM OBLIGATIONS.—

(1) ELECTION TO WHICH SECTION 1281 APPLIES TO ALL OBLIGATIONS HELD DURING TAXABLE YEAR.—A taxpayer may elect to have section 1281 of the Internal Revenue Code of 1954 apply to all short-term obligations described in subsection (b) of such sec-

tion which were held by the taxpayer at any time during the first taxable year ending after the date of the enactment of this Act.

(2) 10-YEAR SPREAD.—In the case of any taxpayer who makes an election under paragraph (1)—

(A) the provisions of section 1281 of the Internal Revenue Code of 1954 (as added by this subtitle) shall be treated as a change in the method of accounting of the taxpayer.

(B) such change shall be treated as having been made with the consent of the Secretary, and

(C) under regulations prescribed by the Secretary of the Treasury or his delegate, the net amount of the adjustments required by section 481(a) of such Code required to be taken into account by the taxpayer in computing taxable income shall be taken into account in each of the 10 taxable years beginning with the taxable year for which such election is made.

(f) TREATMENT OF ORIGINAL ISSUE DISCOUNT ON TAX-EXEMPT OBLIGATIONS.—Section 1288 of such Code (as added by this subtitle) shall apply to obligations issued after September 3, 1982, and acquired after March 1, 1984.

(g) REPEAL OF CAPITAL ASSET REQUIREMENT.—Section 1272 of such Code (as added by this subtitle) shall not apply to any obligation issued before December 31, 1984, which is not a capital asset in the hands of the taxpayer.

(h) REPORTING REQUIREMENTS.—Section 1275(c) of such Code (as added by this subtitle) and the amendments made by section 41(c) shall take effect on the day 30 days after the date of the enactment of this Act.

Subtitle D—Corporate Provisions

PART I—LIMITATIONS ON DIVIDENDS RECEIVED DEDUCTION

SEC. 51. DIVIDENDS RECEIVED DEDUCTION REDUCED WHERE PORTFOLIO STOCK IS DEBT FINANCED.

(a) GENERAL RULE.—Part VIII of subchapter B of chapter 1 (relating to special deductions for corporations) is amended by inserting after section 245 the following new section:

"SEC. 245A. DIVIDENDS RECEIVED DEDUCTION REDUCED WHERE PORTFOLIO STOCK IS DEBT FINANCED.

"(a) GENERAL RULE.—In the case of any dividend on debt-financed portfolio stock, there shall be substituted for the percentage which (but for this subsection) would be used in determining the amount of the deduction allowable under section 243, 244, or 245 a percentage equal to the product of—

"(1) 85 percent, and

"(2) 100 percent minus the average indebtedness percentage.

"(b) SECTION NOT TO APPLY TO DIVIDENDS FOR WHICH 100 PERCENT DIVIDENDS RECEIVED DEDUCTION ALLOWABLE.—Subsection (a) shall not apply to—

"(1) qualifying dividends (as defined in section 243(b) without regard to section 243(c)(4)), and

"(2) dividends received by a small business investment company operating under the Small Business Investment Act of 1958.

"(c) DEBT FINANCED PORTFOLIO STOCK.—For purposes of this section, the term 'debt financed portfolio stock' means any stock of a corporation if—

"(1) as of the beginning of the ex-dividend date, the taxpayer does not own stock of such corporation possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote and does not own at least 50 percent of the total number of shares of all other classes of stock of the corporation, and

"(2) at some time during the base period there is portfolio indebtedness with respect to such stock.

"(d) AVERAGE INDEBTEDNESS PERCENTAGE.—For purposes of this section—

"(1) IN GENERAL.—Except as provided in paragraph (2), the term 'average indebtedness percentage' means the percentage obtained by dividing—

"(A) the average amount (determined under regulations prescribed by the Secretary) of the portfolio indebtedness with respect to the stock during the base period, by

"(B) the average amount (determined under regulations prescribed by the Secretary) of the adjusted basis of the stock during the base period.

"(2) SPECIAL RULE WHERE STOCK NOT HELD THROUGHOUT BASE PERIOD.—In the case of any stock which was not held by the taxpayer throughout the base period—

"(A) paragraph (1) shall be applied by taking into account only the portion of the base period during which the stock was held by the taxpayer, and

"(B) the average indebtedness percentage shall be the amount determined under paragraph (1) (as modified by subparagraph (A)) multiplied by a fraction—

"(i) the numerator of which is the number of days during the base period on which the taxpayer held the stock, and "(ii) the denominator of which is the number of days during the base period.

"(3) PORTFOLIO INDEBTEDNESS.—

"(A) IN GENERAL.—The term 'portfolio indebtedness' means any indebtedness directly attributable to investment in the stock.

"(B) CERTAIN AMOUNTS RECEIVED FROM SHORT SALE TREATED AS INDEBTEDNESS.—For purposes of subparagraph (A), any amount received from a short sale shall be treated as indebtedness for the period beginning on the day on which such amount is received and ending on the day the short sale is closed.

"(4) BASE PERIOD.—The term 'base period' means, with respect to any dividend, the shorter of—

"(A) the period beginning on the ex-dividend date for the most recent previous dividend on the stock and ending on the day before the ex-dividend date for the dividend involved, or

"(B) the 1-year period ending on the day before the ex-dividend date for the dividend involved.

"(e) REDUCTION IN DIVIDENDS RECEIVED DEDUCTION NOT TO EXCEED ALLOCABLE INTEREST.—Under regulations prescribed by the Secretary, any reduction under this section in the amount allowable as a deduction under section 243, 244, or 245 with respect to any dividend shall not exceed the amount of any interest deduction (including any deductible short sale expense) allocable to such dividend."

(b) CLERICAL AMENDMENT.—The table of sections for part VIII of subchapter B of chapter 1 is amended by inserting after the item relating to section 245 the following new item:

"Sec. 245A. Dividends received deduction reduced where portfolio stock is debt financed."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to stock the holding period for which begins after the date of the enactment of this Act in taxable years ending after such date.

SEC. 52. TREATMENT OF DIVIDENDS FROM REGULATED INVESTMENT COMPANIES.

(a) GENERAL RULE.—Subsection (b) of section 854 (relating to limitations applicable to dividends received from regulated investment company) is amended by adding at the end thereof the following new paragraph:

"(4) SPECIAL RULE FOR COMPUTING DEDUCTION UNDER SECTION 243.—For purposes of computing the deduction under section 243—

"(A) paragraph (1) shall be applied by substituting '100 percent' for '75 percent', and

"(B) an amount shall be treated as a dividend for purposes of paragraph (1) only if a deduction would have been allowable under section 243 to the regulated investment company (determined as if section 243 applied to dividends received by a regulated investment company)."

(b) EFFECTIVE DATE.—The amendment made by this subsection (a) shall apply to taxable years of regulated investment companies beginning after the date of the enactment of this Act.

PART II—TREATMENT OF CERTAIN DISTRIBUTIONS

SEC. 53. CORPORATE SHAREHOLDER'S BASIS IN STOCK REDUCED BY NONTAXED PORTION OF EXTRAORDINARY DIVIDENDS.

(a) GENERAL RULE.—Part IV of subchapter O of chapter 1 (relating to special rules for gain or loss on disposition of property) is amended by redesignating section 1059 as section 1060 and by inserting after section 1058 the following new section:

"SEC. 1059. CORPORATE SHAREHOLDER'S BASIS IN STOCK REDUCED BY NONTAXED PORTION OF EXTRAORDINARY DIVIDENDS.

"(a) GENERAL RULE.—If any corporation—

"(1) receives an extraordinary dividend with respect to any share of stock, and

"(2) sells or otherwise disposes of such stock before such stock has been held for more than 1 year.

the basis of such corporation in such stock shall be reduced by the nontaxed portion of such dividend.

"(b) Nontaxed Portion.—For purposes of this section—

"(1) In general.—The nontaxed portion of any dividend is the excess (if any) of—

"(A) the amount of such dividend, over

"(B) the taxable portion of such dividend.

"(2) Taxable portion.—The taxable portion of any dividend is—

"(A) the portion of such dividend includible in gross income, reduced by

"(B) the amount of any deduction allowable with respect to such dividend under section 243, 244, or 245.

"(c) Extraordinary Dividend Defined.—For purposes of this section—

"(1) In general.—The term 'extraordinary dividend' means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds the threshold percentage of the taxpayer's adjusted basis in such share of stock (determined without regard to this section).

"(2) THRESHOLD PERCENTAGE.—The term 'threshold percentage' means—

"(A) 5 percent in the case of stock which is preferred as to dividends, and

"(B) 10 percent in the case of any other stock.

"(3) AGGREGATION OF DIVIDENDS.—

"(A) AGGREGATION WITHIN 90-DAY PERIOD.—All dividends—

"(i) which are received by the taxpayer (or person described in subparagraph (C)) with respect to any share of stock, and

"(ii) which have ex-dividend dates within the same period of 90 consecutive days,

shall be treated as 1 dividend.

"(B) AGGREGATION WITHIN 1 YEAR WHERE DIVIDENDS EXCEED 20 PERCENT OF ADJUSTED BASIS.—All dividends—

"(i) which are received by the taxpayer (or a person described in subparagraph (C)) with respect to any share of stock, and

"(ii) which have ex-dividend dates during the same period of 365 consecutive days, shall be treated as extraordinary dividends if the aggregate of such dividends exceeds 20 percent of the taxpayer's adjusted basis in such stock (determined without regard to this section).

"(C) SUBSTITUTED BASIS TRANSACTIONS.—In the case of any stock, a person is described in this subparagraph if—

"(i) the basis of such stock in the hands of such person is determined in whole or in part by reference to the basis of such stock in the hands of the taxpayer, or

"(ii) the basis of such stock in the hands of the taxpayer is determined in whole or in part by reference to the basis of such stock in the hands of such person.

"(d) SPECIAL RULES.—For purposes of this section—

"(1) TIME FOR REDUCTION.—Any reduction in basis under subsection (a) by reason of any distribution which is an extraordinary dividend shall occur at the beginning of the ex-dividend date for such distribution.

"(2) DISTRIBUTIONS IN KIND.—To the extent any dividend consists of property other than cash, the amount of such dividend shall be treated as the fair market value of such property as of the date of the distribution.

"(3) DETERMINATION OF HOLDING PERIOD.—For purposes of determining the holding period of stock under subsection (a)(2), rules similar to the rules of paragraphs (3) and (4) of section 246(c) shall apply; except that the period taken into account under paragraph (3)(B) of such section shall be 1 year.

"(4) EX-DIVIDEND DATE.—The term 'ex-dividend' means the date on which the share of stock becomes ex-dividend.

"(5) EXTENSION TO CERTAIN PROPERTY DISTRIBUTIONS.—In the case of any distribution of property (other than cash) to which section 301 applies—

"(A) such distribution shall be treated as a dividend without regard to whether the corporation has earnings and profits, and

"(B) the amount of such distribution shall be reduced by the amount of any reduction in basis under section 301(c)(2) by reason of such distribution.

"(e) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section including regulations providing for the application of this section in the case of stock dividends, stock splits, reorganizations, and other similar transactions."

(b) RULES FOR COMPUTING HOLDING PERIODS.—

(1) Subsection (c) of section 246 (relating to the exclusion of certain dividends) is amended by adding at the end thereof the following new paragraph:

"(4) HOLDING PERIOD REDUCED FOR PERIODS WHERE RISK OF LOSS SUBSTANTIALLY DIMINISHED.—The holding periods determined under paragraph (3) shall be appropriately reduced (in the manner provided in regulations prescribed by the Secretary) for any period (during such periods) in which—

"(A) the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities,

"(B) the taxpayer is the grantor of an option to buy substantially identical stock or securities, or

"(C) there is otherwise a substantial diminution of the taxpayer's risk of loss from holding the stock by reason of holding 1 or more other positions.

The preceding sentence shall not apply in the case of a qualified covered call (as defined in section 1092(d)(6))."

(2) Paragraph (3) of section 246(c) is amended by striking out the last sentence.

(c) Conforming Amendments.—

(1) The table of sections for part IV of subchapter O of chapter 1 is amended by striking out the item relating to section 1059 and inserting in lieu thereof the following new items:

"Sec. 1059. Corporate shareholder's basis in stock reduced by nontaxed portion of extraordinary dividends.
"Sec. 1060. Cross references."

(2) Paragraph (1) of section 246(b) (relating to limitation on aggregate amount of deduction) is amended by striking out "and without regard" and inserting in lieu thereof "without regard to any adjustment under section 1059, and without regard".

(3) Section 1016(a) (relating to adjustments to basis) is amended by striking out "and" at the end of paragraph (24), by striking out the period at the end of paragraph (25) and inserting in lieu thereof ", and" and by adding at the end thereof the following new paragraph:

"(26) to the extent provided in section 1059 (relating to reduction in basis for extraordinary dividends)."

(d) Effective Date.—

(1) In general.—Except as provided in paragraph (2), the amendments made by this section shall apply to distributions after March 1, 1984, in taxable years ending after such date.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall apply to stock acquired after the date of the enactment of this Act in taxable years ending after such date.

SEC. 54. DISTRIBUTION OF APPRECIATED PROPERTY BY CORPORATIONS.

(a) GAIN RECOGNIZED ON DISTRIBUTIONS OF APPRECIATED PROPERTY.—

(1) IN GENERAL.—Paragraph (1) of section 311(d) (relating to appreciated property used to redeem stock) is amended to read as follows:

"(1) IN GENERAL.—If—

"(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and

"(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. This subsection shall be applied after the application of subsections (b) and (c)."

(2) EXCEPTIONS.—

(A) Paragraph (2) of section 311(d) is amended by striking out subparagraphs (A) and (B) and inserting in lieu thereof the following:

"(A) a distribution to an 80-percent corporate shareholder if the basis of the property distributed is determined under section 301(d)(2);

"(B) a distribution which is made with respect to qualified stock if—

"(i) section 304(b)(4) applies to such distribution, or

"(ii) such distribution is a qualified dividend;".

(B) Subsection (e) of section 311 is amended by adding at the end thereof the following new paragraphs:

"(3) 80-PERCENT CORPORATE SHAREHOLDER.—The term '80-percent corporate shareholder' means, with respect to any distribution, any corporation which owns—

"(A) stock in the corporation making the distribution possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and

"(B) at least 80 percent of the total number of shares of all other classes of stock of the distributing corporation (except nonvoting stock which is limited and preferred as to dividends).

"(4) QUALIFIED DIVIDEND.—The term 'qualified dividend' means any distribution of property to a shareholder other than a corporation if—

"(A) such distribution is a dividend,

"(B) such property was used by the distributing corporation in the active conduct of a qualified business (as defined in paragraph (2)(B)), and

"(C) such property is not property described in paragraph (1) or (4) of section 1221."

(3) CLERICAL AMENDMENT.—The subsection heading of subsection (d) of section 311 is amended to read as follows:

"(d) DISTRIBUTIONS OF APPRECIATED PROPERTY.—".

(b) HOLDING PERIOD OF CORPORATE DISTRIBUTEE OF APPRECIATED PROPERTY.—Section 301 (relating to distributions of property) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) SPECIAL RULE FOR HOLDING PERIOD OF APPRECIATED PROPERTY DISTRIBUTED TO CORPORATION.—For purposes of this subtitle, if—

"(1) property is distributed to a corporation, and

"(2) the basis of such property in the hands of such corporation is determined under subsection (d)(2)(B),

then such corporation shall not be treated as holding the distributed property during any period before the date on which such corporation's holding period in the stock began."

(c) CROSS REFERENCE.—Paragraph (13) of section 1223 (relating to holding period of property) is amended to read as follows:

"(13) CROSS REFERENCES.—

"(A) For special holding period provision relating to certain partnership distributions, see section 735(b).

"(B) For special holding period provision relating to distributions of appreciated property to corporations, see section 301(e)."

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to distributions declared after the date of the enactment of this Act in taxable years ending after such date.

(2) EXCEPTION FOR CERTAIN DISTRIBUTIONS.—The amendments made by this section (other than subsection (b)) shall not apply to distributions before February 1, 1986, of interests in a royalty trust if—

(A) a group of one or more shareholders held at least 10 percent of the outstanding stock of the corporation making such distribution on February 1, 1984,

(B) such group (acting in concert) acquired at least 10 percent of the outstanding stock of a corporation controlled (within the meaning of section 368(c) of the Internal Revenue Code of 1954) by such corporation during the 1-year period ending on February 1, 1984,

(C) such group submitted a proposal for distributions of interests in a royalty trust from such corporation or such controlled corporation, and

(D) such corporation acquired control of such controlled corporation during the 1-year period ending on February 1, 1984.

SEC. 55. EXTENSION OF HOLDING PERIOD FOR LOSSES ATTRIBUTABLE TO CAPITAL GAIN DIVIDENDS OF REGULATED INVESTMENT COMPANIES OR REAL ESTATE INVESTMENT TRUSTS.

(a) REGULATED INVESTMENT COMPANIES.—

(1) IN GENERAL.—Subparagraph (A) of section 852(b)(4) (relating to loss attributable to capital gain dividend) is amended to read as follows:

"(A) LOSS ATTRIBUTABLE TO CAPITAL GAIN DIVIDEND.—If—

"(i) subparagraph (B) or (D) of paragraph (3) provides that any amount with respect to any share is to be treated as a long-term capital gain, and

"(ii) such share is held by the taxpayer for less than 6 months,

then any loss (to the extent not disallowed under subparagraph (B)) on the sale or exchange of such share shall, to the extent of the amount described in clause (i), be treated as a long-term capital loss."

(2) DETERMINATION OF HOLDING PERIODS.—Subparagraph (C) of section 852(b)(4) is amended to read as follows:

"(C) DETERMINATION OF HOLDING PERIODS.—For purposes of this paragraph, the rules of paragraphs (3) and (4) of section 246(c) shall apply in determining the period for which the taxpayer held any share of stock; except that for the number of days specified in subparagraph (B) of section 246(c)(3) there shall be substituted—

"(i) '6 months' for purposes of subparagraph (A), and

"(ii) '30 days' for purposes of subparagraph (B)."

(3) EXCEPTION FOR LOSSES INCURRED UNDER PERIODIC LIQUIDATION PLANS.—Paragraph (4) of section 852(b) is amended by adding at the end thereof the following new subparagraph:

"(D) LOSSES INCURRED UNDER A PERIODIC LIQUIDATION PLAN.—To the extent provided in regulations, subparagraph (A) shall not apply to losses incurred on the sale or exchange of shares of stock in a regulated investment company pursuant to a plan which provides for the periodic liquidation of such shares."

(b) REAL ESTATE INVESTMENT TRUST.—Paragraph (7) of section 857(b) (relating to loss on sale or exchange of stock in real estate investment trust) is amended to read as follows:

"(7) LOSS ON SALE OR EXCHANGE OF STOCK HELD LESS THAN 6 MONTHS.—

"(A) IN GENERAL.—If—

"(i) subparagraph (B) of paragraph (3) provides that any amount with respect to any share or beneficial interest is to be treated as a long-term capital gain, and

"(ii) the taxpayer has held such share or interest for less than 6 months, then any loss on the sale or exchange of such share or interest shall, to the extent of the amount described in clause (i), be treated as loss from the sale or exchange of a capital asset held for more than 1 year.

"(B) DETERMINATION OF HOLDING PERIOD.—For purposes of this paragraph, the rules of paragraphs (3) and (4) of section 246(c) shall apply in determining the period for which the taxpayer has held any share of stock or beneficial interest; except that '6 months' shall be substituted for the number of days specified in subparagraph (B) of section 246(c)(3).

"(C) EXCEPTION FOR LOSSES INCURRED UNDER PERIODIC LIQUIDATION PLANS.—To the extent provided in regulations, subparagraph (A) shall not apply to any loss incurred on the sale or exchange of shares of stock of, or beneficial interest in, a real estate investment trust pursuant to a plan which provides for the periodic liquidation of such shares or interests."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to losses incurred with respect to shares of stock and beneficial interests with respect to which the taxpayer's holding period begins after the date of the enactment of this Act.

PART III—MISCELLANEOUS PROVISIONS

SEC. 56. DENIAL OF DEDUCTIONS FOR CERTAIN EXPENSES INCURRED IN CONNECTION WITH SHORT SALES.

(a) SHORT SALE PAYMENTS ATTRIBUTABLE TO DIVIDENDS.—Section 263 (relating to capital expenditures) is amended by adding at the end thereof the following new subsection:

"(h) PAYMENTS IN LIEU OF DIVIDENDS IN CONNECTION WITH SHORT SALES.—

"(1) IN GENERAL.—If—

"(A) a taxpayer makes any payment with respect to any stock used by such taxpayer in a short sale and such payment is in lieu of a dividend payment on such stock, and

"(B) the closing of such short sale occurs on or before the 15th day after the date of such short sale,

then no deduction shall be allowed for such payment. The basis of the stock used to close the short sale shall be increased by the amount not allowed as a deduction by reason of the preceding sentence.

"(2) LONGER PERIOD IN CASE OF EXTRAORDINARY DIVIDENDS.—If the payment described in paragraph (1)(A) is in respect of an extraordinary dividend, paragraph (1)(B) shall be applied by substituting 'the day 1 year after the date of such short sale' for 'the 15th day after the date of such short sale'.

"(3) EXTRAORDINARY DIVIDEND.—For purposes of this subsection, the term 'extraordinary dividend' has the meaning given to such term by section 1059(c); except that such section shall be applied by treating the amount realized by the taxpayer in the short sale as his adjusted basis in the stock.

"(4) SPECIAL RULE WHERE RISK OF LOSS SUBSTANTIALLY DIMINISHED.—The running of any period of time applicable under paragraph (1)(B) (as modified by paragraph (2)) shall be suspended during any period in which—

"(A) the taxpayer holds, has an option to buy, or is under a contractual obligation to buy, substantially identical stock or securities, or

"(B) there is otherwise a substantial diminution of the taxpayer's risk of loss from the short sale by reason of holding 1 or more other positions."

(b) INVESTMENT INTEREST TO INCLUDE CERTAIN EXPENSES INVOLVING SHORT SALES.—Subparagraph (D) of section 163(d)(3) (defining investment interest) is amended to read as follows:

"(D) INVESTMENT INTEREST.—

"(i) IN GENERAL.—The term 'investment interest' means interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment.

"(ii) CERTAIN EXPENSES INCURRED IN CONNECTION WITH SHORT SALES.—For purposes of clause (i), the term 'interest' includes any amount allowable as a deduction in connection with the personal property used in a short sale."

(c) INTEREST FOR PURPOSES OF SECTION 265(2) TO INCLUDE CERTAIN EXPENSES INVOLVING SHORT SALES.—Section 265(2) (relating to denial of deduction for interest relating to tax-exempt income) is amended by adding at the end thereof the following new sentence: "For purposes of this paragraph, the term 'interest' includes any amount paid or incurred in connection with the personal property used in a short sale."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to short sales after the date of the enactment of this Act in taxable years ending after such date.

SEC. 57. NONRECOGNITION OF GAIN OR LOSS BY CORPORATION ON OPTIONS WITH RESPECT TO ITS STOCK.

(a) GENERAL RULE.—Subsection (a) of section 1032 (relating to exchange of stock for property) is amended by adding at the end thereof the following new sentence: "No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to options acquired or lapsed after the date of the enactment of this Act in taxable years ending after such date.

SEC. 58. AMENDMENTS TO ACCUMULATED EARNINGS TAX.

(a) CLARIFICATION THAT TAX APPLIES TO CORPORATIONS WHICH ARE NOT CLOSELY HELD.—Section 532 (relating to corporations subject to accumulated earnings tax) is amended by adding at the end thereof the following new subsection:

"(c) APPLICATION DETERMINED WITHOUT REGARD TO NUMBER OF SHAREHOLDERS.—The application of this part to a corporation shall be determined without regard to the number of shareholders of such corporation."

(b) TREATMENT OF CAPITAL GAINS AND LOSSES.—

(1) IN GENERAL.—Subsection (b) of section 535 (defining accumulated taxable income) is amended by

striking out paragraphs (5), (6), and (7) and inserting in lieu thereof the following:

"(5) CAPITAL LOSSES.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), there shall be allowed as a deduction an amount equal to the net capital loss for the taxable year.

"(B) RECAPTURE OF PREVIOUS DEDUCTIONS FOR CAPITAL GAINS.—The aggregate amount allowable as a deduction under subparagraph (A) for any taxable year shall be reduced by the lesser of—

"(i) the nonrecaptured capital gains deductions, or

"(ii) the amount of the accumulated earnings and profits of the corporation as of the close of the preceding taxable year.

"(C) NONRECAPTURED CAPITAL GAINS DEDUCTIONS.—For purposes of subpargraph (B), the term 'nonrecaptured capital gains deductions' means the excess of—

"(i) the aggregate amount allowable as a deduction under paragraph (6) for preceding taxable years beginning after December 31, 1984, over "(ii) the aggregate of the reductions under subparagraph (B) for preceding taxable years.

"(6) NET CAPITAL GAINS.—

"(A) IN GENERAL.—There shall be allowed as a deduction—

"(i) the net capital gain for the taxable year (determined with the application of paragraph (7)), reduced by

"(ii) the taxes attributable to such net capital gain.

"(B) ATTRIBUTABLE TAXES.—For purposes of subparagraph (A), the taxes attributable to the net capital gain shall be an amount equal to the difference between—

"(i) the taxes imposed by this subtitle (except the tax imposed by this part) for the taxable year, and

"(ii) such taxes computed for such year without including in taxable income the net capital gain for the taxable year (determined without the application of paragraph (7)).

"(7) CAPITAL LOSS CARRYOVERS.—

"(A) UNLIMITED CARRYFORWARD.—The net capital loss for any taxable year shall be treated as a short-term capital loss in the next taxable year.

"(B) SECTION 1212 INAPPLICABLE.—No allowance shall be made for the capital loss carryback or carryforward provided in section 1212.

"(8) SPECIAL RULES FOR MERE HOLDING OR INVESTMENT COMPANIES.—In the case of a mere holding or investment company—

"(A) CAPITAL LOSS DEDUCTION NOT ALLOWED.—Paragraph (5) shall not apply.

"(B) EARNINGS AND PROFITS.—For purposes of subchapter C, the accumulated earnings and profits at any time shall not be less than they would be if this subsection had applied to the computation of earnings and profits for all taxable years beginning after the date of the enactment of the Tax Reform Act of 1984."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 59. REPEAL OF STOCK FOR DEBT EXCEPTION FOR PURPOSES OF DETERMINING INCOME FROM DISCHARGE OF INDEBTEDNESS.

(a) GENERAL RULE.—Subsection (e) of section 108 (relating to income from discharge of indebtedness) is amended by adding at the end thereof the following new paragraph:

"(10) INDEBTEDNESS SATISFIED BY CORPORATION'S STOCK.—

"(A) IN GENERAL.—For purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock.

"(B) EXCEPTION FOR TITLE 11 CASES AND INSOLVENT DEBTORS.—Subparagraph (A) shall not apply in the case of a debtor in a title 11 case or when the debtor is insolvent."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to transfers after the date of the enactment of this Act in taxable years ending after such date.

SEC. 60. DISTRIBUTIONS OF OBLIGATIONS HAVING ORIGINAL ISSUE DISCOUNT.

(a) EFFECT ON EARNINGS AND PROFITS.—

(1) Paragraph (2) of section 312(a) (relating to effect of earnings and profits) is amended to read as follows:

"(2) the principal amount of the obligations of such corporation (or, in the case of obligations having original issue discount, the aggregate issue price of such obligations), and ".

(2) Section 312 is amended by adding at the end thereof the following new subsection:

"(n) DEFINITION OF ORIGINAL ISSUE DISCOUNT AND ISSUE PRICE FOR PURPOSES OF SUBSECTION (a)(2).—For purposes of subsection (a)(2), the terms 'original issue discount' and 'issue price' have the same respective meanings as when used in subpart A of part V of subchapter P of this chapter."

(b) TREATMENT UNDER ORIGINAL ISSUE DISCOUNT RULES.—Subsection (a) of section 1275 (relating to other definitions and special rules), as added by section 41 of this Act, is amended by adding at the end thereof the following new paragraph:

"(4) TREATMENT OF OBLIGATIONS DISTRIBUTED TO CORPORATIONS.—Any debt obligation of a corporation distributed by such corporation with respect to its stock shall be treated as if it had been issued by such corporation for property."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to obligations distributed after the date of the enactment of this Act in taxable years ending after such date.

SEC. 61. ELIGIBILITY TO FILE CONSOLIDATED RETURNS.

(a) IN GENERAL.—Section 1504 (defining affiliated group) is amended by adding at the end thereof the following new subsection:

"(f) DEFINITION OF AFFILIATED GROUP FOR TAXABLE YEARS BEGINNING AFTER 1984.—For taxable years beginning after December 31, 1984—

"(1) IN GENERAL.—Except as provided in paragraph (6), for purposes of this chapter only, the term 'affiliated group' means 1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

"(A) stock possessing—

"(i) at least 80 percent of the voting power of all classes of stock, and

"(ii) at least 80 percent of the total value of shares of all classes of stock of each of the includible corporations (except the common parent corporation), is owned directly by 1 or more of the other includible corporations, and

"(B) the common parent corporation owns directly stock possessing—

"(i) at least 80 percent of the voting power of all classes of stock, and

"(ii) at least 80 percent of the total value of shares of all classes of stock,

of at least 1 of the other includible corporations.

"(2) SPECIAL RULE FOR INITIAL DETERMINATION.—An includible corporation shall not be treated as a member of an affiliated group unless, on the first day of the first taxable year of such corporation otherwise to be included in a consolidated return of such group, the requirements of paragraph (1) are met.

"(3) SPECIAL RULE FOR TERMINATION OF AFFILIATED GROUP.—The determination of whether an affiliated group continues to be an affiliated group (or whether any includible corporation continues to be a member of such group) shall be made by substituting 'more than 50 percent' for 'at least 80 percent' in clause (ii) in paragraph (1)(A) and clause (ii) of paragraph (1)(B).

"(4) 5 YEARS MUST ELAPSE BEFORE REAFFILIATION.—

"(A) IN GENERAL.—For purposes of determining whether any corporation is a member of an affiliated group, a corporation which has ceased to be a member of such group (and any successor of such corporation) may not be treated as a member of such group (or of any other affiliated group which includes the common parent of such group (and any successor of such common parent)) before the 5th taxable year of such corporation after its first taxable year for which it ceases to be a member of such affiliated group.

"(B) SECRETARY MAY WAIVE APPLICATION OF SUBPARAGRAPH (A).—The Secretary may waive the application of subparagraph (A) to any corporation for any period subject to such conditions as the Secretary may by regulations prescribe.

"(5) STOCK.—For purposes of this subsection, the term 'stock' does not include—

"(A) nonvoting stock which is limited and preferred as to dividends and in liquidation and which is not convertible into stock of any other class,

"(B) employer securities (within the meaning of section 409(A)(l)) while such securities are held under a tax credit employee stock ownership plan, and

"(C) qualifying employer securities (within the meaning of section 4975(e)(8)) while such securities are held under an employee stock ownership plan which meets the requirements of section 4975(e)(7).

"(6) CORPORATIONS AFFILIATED ON MARCH 1, 1984.—Subsection (a) (and not paragraphs (1) and (3) of this subsection) shall apply for purposes of determining whether a corporation continues to be a member of an affiliated group of which it was a member on March 1, 1984.

"(7) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations—

"(A) which treat warrants, obligations convertible into stock, and other similar interests as stock, and stock as not stock, for purposes of this chapter,

"(B) which treat options to acquire stock as having been exercised, "(C) which disregard decreases in voting power disproportionate to decreases in the total value of shares of all classes of stock, and

"(D) which do not permit an includible corporation to be a member of an affiliated group where there is a plan pursuant to which it is to cease meeting the qualification requirements for treatment as such a member."

(b) TECHNICAL AMENDMENTS.—Subsection (c) of section 1504 (relating to includible insurance companies) is amended by striking out "subsection (a)" each place it appears and inserting in lieu thereof "subsection (a) or (f), as the case may be,".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984.

Subtitle E—Partnership Provisions

SEC. 71. PARTNERSHIP ALLOCATIONS WITH RESPECT TO CONTRIBUTED PROPERTY.

(a) GENERAL RULE.—Subsection (c) of section 704 (relating to contributed property) is amended to read as follows:

"(c) CONTRIBUTED PROPERTY.—With respect to property contributed to the partnership by a partner, depreciation, depletion, and gain or loss shall, under regulations prescribed by the Secretary, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution."

(b) CONFORMING AMENDMENTS.—The fourth sentence of section 613A(c)(7)(D) and the third sentence of section 743(b) are each amended by striking out "an agreement described in section 704(c)(2) (relating to effect of partnership agreement on contributed property), such share shall be determined by taking such agreement into account" and inserting in lieu thereof "property contributed to the partnership by a partner, section 704(c) (relating to contributed property) shall apply in determining such share".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to property contributed to the partnership after March 31, 1984, in taxable years ending after such date.

SEC. 72. DETERMINATION OF DISTRIBUTIVE SHARES WHEN PARTNER'S INTEREST CHANGES.

(a) GENERAL RULE.—Section 706 (relating to taxable years of partner and partnership) is amended by adding at the end thereof the following new subsection:

"(d) DETERMINATION OF DISTRIBUTIVE SHARE WHEN PARTNER'S INTEREST CHANGES.—

"(1) IN GENERAL.—Except as provided in paragraphs (2) and (3), if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.

"(2) CERTAIN CASH BASIS ITEMS PRORATED OVER PERIOD TO WHICH ATTRIBUTABLE.—

"(A) IN GENERAL.—If during any taxable year of the partnership there is a change in any partner's interest in the partnership, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item shall be determined—

"(i) by assigning the appropriate portion of each such item to each day in the period (during the taxable year) to which it is attributable, and

"(ii) by allocating the portion assigned to any such day among the partners in proportion to their interests in the partnership at the close of such day.

"(B) ALLOCABLE CASH BASIS ITEM.—For purposes of this paragraph, the term 'allocable cash basis item' means any of the following items which are described in paragraph (1) and with respect to which the partnership uses the cash receipts and disbursements method of accounting:

"(i) Interest.

"(ii) Taxes.

"(iii) Payments for services or for the use of property.

"(iv) Any other item of a kind specified in regulations prescribed by the Secretary as being an item with respect to which the application of this paragraph is appropriate to avoid significant misstatements of the income of the partners.

"(C) ITEMS ATTRIBUTABLE TO PERIODS NOT WITHIN TAXABLE YEAR.—To the extent that any allocable cash basis item is attributable to—

"(i) periods before the beginning of the taxable year, such item shall be assigned under subparagraph (A)(i) to the first day of such taxable year, or "(ii) periods after the close of the taxable year, such item shall be assigned under subparagraph (A)(i) to the last day of the taxable year.

"(3) ITEMS ATTRIBUTABLE TO INTEREST IN OTHER PARTNERSHIP PRORATED OVER ENTIRE TAXABLE YEAR.—If—

"(A) during any taxable year of the partnership there is a change in any partner's interest in the partnership, and

"(B) such partnership is a partner in another partnership,

then (except to the extent provided in regulations) each partner's distributive share of any item attributable to the other partnership shall be determined by assigning an equal portion of each such item to each day during the taxable year of the partnership (during which such partnership is a partner in the other partnership) and by allocating the portion assigned to any such day among the partners in proportion to their interests in the partnership at the close of such day.

"(4) TAXABLE YEAR DETERMINED WITHOUT REGARD TO SUBSECTION (c)(2)(A).—For purposes of this subsection, the taxable year of a partnership shall be determined without regard to subsection (c)(2)(A)."

(b) CONFORMING AMENDMENTS.—Paragraph (2) of section 706(c) is amended—

(1) by striking out the last sentence of subparagraph (A), and

(2) by striking out ", but such partner's distributive share of items described in section 702(a) shall be determined by taking into account his varying interests in the partnership during the taxable year" in subparagraph (B).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply—

(1) in the case of items described in section 706(d)(2) of the Internal Revenue Code of 1954 (as added by subsection (a)), to amounts attributable to periods after March 31, 1984, and

(2) in the case of items described in section 706(d)(3) of such Code (as added by subsection (a)), to amounts paid or accrued by the other partnership after March 31, 1984.

SEC. 73. PAYMENTS TO PARTNERS FOR PROPERTY OR CERTAIN SERVICES.

(a) GENERAL RULE.—Section 707 (relating to transactions between partner and partnership) is amended by adding at the end thereof the following new subsection:

"(d) TREATMENT OF PAYMENTS TO PARTNERS FOR PROPERTY OR CERTAIN SERVICES.—

"(1) PROPERTY TRANSFERS.—If—

"(A) there is a transfer of money (or other property) by a partner to a partnership, and

"(B) there is a related direct or indirect transfer of money (or other property) to such partner or another partner from the partnership,

the transaction shall be considered as a sale of property.

"(2) SERVICES AND PROPERTY PROPERLY CHARGEABLE TO CAPITAL ACCOUNT.—If—

"(A) a partner performs services for a partnership or transfers property to a partnership,

"(B) the direct payment by the partnership for such services or property would constitute an amount chargeable to capital account, and

"(C) there is a related direct or indirect allocation of income or gain (or item thereof) to such partner,

such transaction (including any related distribution) shall be treated as described in subsection (a) or (c) (whichever is appropriate); and the allocation referred to in subparagraph (C) shall be disregarded for purposes of this subtitle.

"(3) TREATMENT OF PERSONS BECOMING PARTNER.—For purposes of this subsection, a person shall be treated as a partner with respect to any transfer of property or performance of services if such person becomes a partner in the partnership after such transfer or performance of such service.

"(4) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to services performed or property transferred after March 1, 1984.

SEC. 74. CONTRIBUTIONS TO A PARTNERSHIP OF UNREALIZED RECEIVABLES, INVENTORY ITEMS, OR CAPITAL LOSS PROPERTY.

(a) GENERAL RULE.—Subpart A of part II of subchapter K of chapter 1 (relating to contributions to a partnership) is amended by adding at the end thereof the following new section:

"SEC. 724. CHARACTER OF GAIN OR LOSS ON CONTRIBUTED UNREALIZED RECEIVABLES, INVENTORY ITEMS, AND CAPITAL LOSS PROPERTY.

"(a) CONTRIBUTIONS OF UNREALIZED RECEIVABLES.—In the case of any property which—

"(1) was contributed to the partnership by a partner, and

"(2) was an unrealized receivable in the hands of such partner immediately before such contribution,

any gain or loss recognized by the partnership on the disposition of such property shall be treated as ordinary income or ordinary loss, as the case may be.

"(b) CONTRIBUTIONS OF INVENTORY ITEMS.—In the case of any property which—

"(1) was contributed to the partnership by a partner, and

"(2) was an inventory item in the hands of such partner immediately before such contribution,

any gain or loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as ordinary income or ordinary loss, as the case may be.

"(c) CONTRIBUTIONS OF CAPITAL LOSS PROPERTY.—In the case of any property which—

"(1) was contributed by a partner to the partnership, and

"(2) was a capital asset in the hands of such partner immediately before such contribution,

any loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as a loss from the sale of a capital asset to the extent that, immediately before such contribution, the adjusted basis of such property in the hands of the partner exceeded the fair market value of such property.

"(d) DEFINITIONS.—For purposes of this section—

"(1) UNREALIZED RECEIVABLE.—The term 'unrealized receivable' has the meaning given such term by section 751(c) (determined by treating any reference to the partnership as referring to the partner).

"(2) INVENTORY ITEM.—The term 'inventory item' has the meaning given such term by section 751(d)(2) (determined by treating any reference to the partnership as referring to the partner and by applying section 1231 without regard to any holding period therein provided).

"(3) SUBSTITUTED BASIS PROPERTY.—If any property described in subsection (a), (b), or (c) is disposed of in a nonrecognition transaction, the tax treatment which applies to such property under such subsection shall also apply—

"(A) to such property in the hands of the person acquiring such property if such property is transferred basis property in the hands of such person, and

"(B) to any exchanged basis property received by the taxpayer in the transaction."

(b) Amendment of Section 735.—Section 735 (relating to character of gain or loss on disposition of distributed property) is amended by adding at the end thereof the following new subsection:

"(c) Special Rules.—

"(1) Waiver of holding periods contained in section 1231.—For purposes of this section, section 751(d)(2) (defining inventory item) shall be applied without regard to any holding period in section 1231(b).

"(2) Substituted basis property.—If any property described in subsection (a) is disposed of in a nonrecognition transaction, the tax treatment which applies to such property under such subsection shall also apply—

"(A) to such property in the hands of the person acquiring such property if such property is transferred basis property in the hands of such person, and

"(B) if subparagraph (A) does not apply, to any exchanged basis property received by the taxpayer in the transaction."

(c) CLERICAL AMENDMENT.—The table of sections for subpart A of part II of subchapter K of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 724. Character of gain or loss on contributed unrealized receivables, inventory items, and capital loss property."

(d) EFFECTIVE DATES.—

(1) IN GENERAL.— Except as provided in paragraph (2), the amendments made by this section shall apply to property contributed to the partnership after March 31, 1984, in taxable years ending after such date.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to property distributed after March 31, 1984, in taxable years ending after such date.

SEC. 75. TRANSFERS OF PARTNERSHIP INTERESTS BY CORPORATIONS.

(a) GENERAL RULE.—Subpart C of part II of subchapter K of chapter 1 (relating to transfer of interests in a partnership) is amended by adding at the end thereof the following new section:

"SEC. 744. TRANSFERS OF PARTNERSHIP INTERESTS BY CORPORATIONS.

"(a) CORPORATE DISTRIBUTIONS.—For purposes of determining the amount of gain recognized by a corporation on any distribution, any distribution of an interest in a partnership shall be treated as a distribution of the corporation's proportionate share of the recognition property of such partnership.

"(b) SALES OR EXCHANGE TO WHICH SECTION 337 APPLIES.—For purposes of determining the amount of gain recognized on a sale or exchange described in section 337, any sale or exchange by a corporation of an interest in a partnership shall be treated as a sale or exchange of the corporation's proportionate share of the recognition property of such partnership.

"(c) RECOGNITION PROPERTY.—For purposes of this section, the term 'recognition property' means any property with respect to which gain would be recognized to the corporation if such property—

"(1) were distributed by the corporation in a distribution described in section 311 or 336, or

"(2) were sold in a sale described in section 337.

In determining whether property of a partnership is recognition property, such partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner.

"(d) LIMITATION ON AMOUNT OF GAIN RECOGNIZED.—The amount of any gain recognized by reason of subsection (a) or (b) shall not exceed the amount of the gain which would have been recognized if the partnership interst had been sold (or, in any case to which subsection (b) applies, if section 337 did not apply).

"(e) EXTENSION TO TRUSTS.—Under regulations, rules similar to the rules of this section shall also apply in the case of interests in trusts."

(b) ADJUSTMENT OF TRANSFEREE'S BASIS IN PARTNERSHIP PROPERTY.—Subsections (a) and (b) of section 743 (relating to optional adjustment to basis of partnership property) are each amended by inserting", by distribution," after "sale or exchange".

(c) TECHNICAL AMENDMENT TO SECTION 751(c).—The last sentence of section 751(c) (defining unrealized receivables) is amended by striking out "at its fair market value".

(d) CLERICAL AMENDMENT.—The table of sections for subpart C of part II of subchapter K of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 744. Transfers of partnership interests by corporations."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions, sales, and exchanges made after March 1, 1984, in taxable years ending after such date.

SEC. 76. APPLICATION OF SECTION 751 IN THE CASE OF TIERED PARTNERSHIPS

(a) GENERAL RULE.—Section 751 (relating to unrealized receivables and inventory items) is amended by adding at the end thereof the following new subsection:

"(f) SPECIAL RULES IN THE CASE OF TIERED PARTNERSHIPS, ETC.—In determining whether property of a partnership is—

"(1) an unrealized receivable, or

"(2) an inventory item,

such partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner. Under regulations, rules similar to the rules of the preceding sentence shall also apply in the case of interests in trusts."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to distributions, sales, and exchanges made after March 31, 1984, in taxable years ending after such date.

SEC. 77. SECTION 1031 NOT APPLICABLE TO PARTNERSHIP INTERESTS; LIMITATION ON THE PERIOD DURING WHICH LIKE KIND EXCHANGES MAY BE MADE.

(a) IN GENERAL.—Subsection (a) of section 1031 (relating to nonrecognition of gain or loss from exchanges solely in kind) is amended to read as follows:

"(a) NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN KIND.—

"(1) IN GENERAL.—No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

"(2) EXCEPTION.—This subsection shall not apply to any exchange of—

"(A) stock in trade or other property held primarily for sale,

"(B) stocks, bonds, notes,

"(C) other securities or evidences of indebtedness or interest,

"(D) interests in a partnership,

"(E) certificates of trust or beneficial interests, or

"(F) choses in action.

"(3) REQUIREMENT THAT EXCHANGE BE COMPLETED NOT MORE THAN 180 DAYS AFTER TRANSFER OF EXCHANGED PROPERTY.—For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if such property is received after the earlier of—

"(A) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

"(B) the due date (determined with regard to extensions) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendment made by subsection (a) shall apply to transfers made after March 31, 1984, in taxable years ending after such date.

(2) BINDING CONTRACT EXCEPTION FOR TRANSFER OF PARTNERSHIP INTERESTS.—Paragraph (2)(D) of section 1031(a) of the Internal Revenue Code of 1954 (as amended by subsection (a)) shall not apply in the case of any exchange pursuant to a binding contract in effect on March 1, 1984, and at all times thereafter before the exchange.

(3) REQUIREMENT THAT EXCHANGE BE COMPLETED WITHIN 180 DAYS.—Paragraph (3) of section

1031(a) of the Internal Revenue Code of 1954 (as amended by subsection (a)) shall apply—

(A) to transfers after the date of the enactment of this Act, and

(B) to transfers on or before such date of enactment if the property to be received in the exchange is not received before January 1, 1987.

In the case of any transfer on or before the date of the enactment of this Act which the taxpayer treated as part of a like-kind exchange, the period for assessing any deficiency of tax attributable to the amendment made by subsection (a) shall not expire before January 1, 1988.

SEC. 78. ELIMINATION OF BASIS STRIPS UNDER SECTION 734(b).

(a) GENERAL RULE.—Subsection (b) of section 734 is amended by adding at the end thereof the following new sentence: "Paragraph (1)(B) shall not apply to any property which is an interest in another partnership with respect to which the election provided in section 754 is not in effect."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to distributions after March 1, 1984, in taxable years ending after such date.

SEC. 79. OVERRULING OF RAPHAN CASE.

Section 752 (relating to treatment of certain liabilities) is amended by adding at the end thereof of the following new subsection:

"(e) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

Subtitle F—Trust Provisions

SEC. 81. TREATMENT OF PROPERTY DISTRIBUTED IN KIND.

(a) GENERAL RULE.—Section 643 (relating to definitions applicable to subchapters A, B, C, and D) is amended by adding at the end thereof the following new subsection:

"(d) TREATMENT OF PROPERTY DISTRIBUTED IN KIND.—

"(1) BASIS OF BENEFICIARY.—The basis of any property received by a beneficiary in a distribution from an estate or trust shall be—

"(A) the adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for

"(B) any gain or loss recognized to the estate or trust on the distribution.

"(2) TREATMENT OF PROPERTY DISTRIBUTIONS.—In the case of any distribution of property (other than cash)—

"(A) gain or loss shall be recognized by the estate or trust in the same manner as if such property had been sold to the distributee at its fair market value, and

"(B) the amount taken into account under sections 661(a)(2) and 662(a)(2) shall be the fair market value of such property.

"(3) ELECTION TO HAVE PARAGRAPH (2) NOT APPLY.—In the case of any distribution of property (other than cash) to which an election under this paragraph applies—

"(A) paragraph (2) shall not apply, and

"(B) the amount taken into account under sections 661(a)(2) and 662(a)(2) shall be the lesser of the basis of such property in the hands of the beneficiary (as determined under paragraph (1)) or the fair market value of such property."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to distributions after March 1, 1984, in taxable years ending after such date.

SEC. 82. TREATMENT OF MULTIPLE TRUSTS.

(a) GENERAL RULE.—Section 643 (relating to definitions applicable to subparts A, B, C, and D) is amended by adding at the end thereof the following new subsection:

"(e) TREATMENT OF MULTIPLE TRUSTS.—For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if—

"(1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and

"(2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.

For purposes of the preceding sentence, a husband and wife shall be treated as 1 person."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after March 1, 1984.

Subtitle G—Accounting Changes

SEC. 91. CERTAIN AMOUNTS NOT TREATED AS INCURRED BEFORE ECONOMIC PERFORMANCE.

(a) IN GENERAL.—Section 461 (relating to general rule for taxable year of deduction) is amended by adding at the end thereof the following new subsections:

"(h) CERTAIN LIABILITIES NOT INCURRED BEFORE ECONOMIC PERFORMANCE.—

"(1) IN GENERAL.—For purposes of this title, in determining whether an amount has been incurred with respect to any item during any taxable year, all of the events which establish liability for such amount shall not be treated as having occurred any earlier than when economic performance with respect to such item occurs.

"(2) TIME WHEN ECONOMIC PERFORMANCE OCCURS.—Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs shall be determined under the following principles:

"(A) PROPERTY AND SERVICES.—If the liability of the taxpayer requires a payment to another person for—

"(i) the providing of property or services to the taxpayer by another person, economic performance occurs when such person provides such property or services, or

"(ii) the use of property by the taxpayer, economic performance occurs as the taxpayer uses such property.

"(B) PROVIDING OF SERVICES OR PROPERTY BY THE TAXPAYER.—If the liability of the taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services.

"(C) WORKERS COMPENSATION, TORT, AND EMPLOYEE BENEFIT LIABILITIES OF THE TAX-

PAYER.—If the liability of the taxpayer requires a payment to another person and—

"(i) arises under any workers compensation act,

"(ii) arises out of any tort, or

"(iii) arises under any contractual liability of the taxpayer to provide benefits to employees of the taxpayer (other than through a plan subject to the requirements of section 404 or 404A or through a fund to which section 419 applies), economic performance occurs as the payments to such person are made. Subparagraphs (A) and (B) shall not apply to any liability described in the preceding sentence.

"(D) OTHER ITEMS.—In the case of any other liability of the taxpayer, economic performance occurs at the time determined under regulations prescribed by the Secretary.

"(3) SUBSECTION NOT TO APPLY TO CERTAIN CASES TO WHICH OTHER PROVISIONS OF THIS TITLE SPECIFICALLY APPLY.—This subsection shall not apply to any item to which any of the following provisions apply:

"(A) Subsection (c) or (f) of section 166 (relating to reserves for bad debts).

"(B) Section 463 (relating to vacation pay).

"(C) Section 466 (relating to discount coupons).

"(D) Any other provisions of this title which specifically provides for a deduction for a reserve for estimated expenses.

"(i) TAX SHELTERS MAY NOT DEDUCT ITEMS EARLIER THAN WHEN ECONOMIC PERFORMANCE OCCURS.—

"(1) IN GENERAL.—In the case of a tax shelter computing taxable income under the cash receipts and disbursement method of accounting, such tax shelter shall not be allowed a deduction under this chapter with respect to any item before the time when such item would be treated as incurred under subsection (h).

"(2) TAX SHELTER DEFINED.—For purposes of this section, the term 'tax shelter' means—

"(A) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offerings of security for sale, "(B) any syndicate (within the meaning of section 1256(e)(3)(B)), and

"(C) any tax shelter (within the meaning of section 6661(b)(2)(C)(ii)).

"(3) SPECIAL RULE FOR FARMING.—In the case of the trade or business of farming (as defined in section 464(e)), this section shall apply only to a farming syndicate (as defined in section 464(c)). The preceding sentence shall not apply to a tax shelter described in paragraph (2)(C)."

(b) 10-YEAR NET OPERATING LOSS CARRYBACK PERIOD FOR DEFERRED STATUTORY OR TORT LIABILITY DEDUCTIONS.—

(1) IN GENERAL.—Paragraph (1) of section 172(b) (relating to years to which loss may be carried) is amended by adding at the end thereof the following new subparagraph:

"(K) SPECIAL RULE FOR DEFERRED STATUTORY OR TORT LIABILITY LOSSES.—In the case of a taxpayer which has a deferred statutory or tort liability loss (as defined in subsection (k)) for any taxable year beginning after December 31, 1983, the deferred statutory or tort liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss."

(2) DEFERRED STATUTORY OR TORT LIABILITY LOSSES.—Section 172 is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

"(k) DEFINITIONS AND SPECIAL RULES RELATING TO DEFERRED STATUTORY OR TORT LIABILITY LOSSES.—For purposes of this section—

"(1) DEFERRED STATUTORY OR TORT LIABILITY LOSS.—The term 'deferred statutory or tort liability loss' means, for any taxable year, the lesser of—

"(A) the net operating loss for such taxable year, reduced by any portion thereof attributable to—

"(i) a foreign expropriation loss, or

"(ii) a product liability loss, or

"(B) the sum of the amounts allowable as a deduction under this chapter (other than any deduction described in subsection (j)(1)(B)) which—

"(i) is taken into account in computing the net operating loss for such taxable year, and

"(ii) is for an amount incurred with respect to a liability which arises under a Federal or State law or out of any tort of the taxpayer and—

"(I) in the case of a liability arising out of a Federal or State law, the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of such taxable year, or

"(II) in the case of a liability arising out of a tort, such liability arises out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurs at least 3 years before the beginning of such taxable year.

A liability shall not be taken into account under the preceding sentence unless the taxpayer used an accrual method of accounting throughout the period or periods during which the acts or failures to act giving rise to such liability occurred.

"(2) SPECIAL RULE FOR NUCLEAR POWERPLANTS.—Except as provided in regulations prescribed by the Secretary, that portion of a deferred statutory or tort liability loss which is attributable to amounts incurred in the decommissioning of a nuclear powerplant (or any unit thereof) may, for purposes of subsection (b)(1)(K), be carried back to each of the taxable years during the period—

"(A) beginning with the taxable year in which such plant (or unit thereof) was placed in service, and

"(B) ending with the taxable year preceding the loss year.

"(3) COORDINATION WITH SUBSECTION (b)(2).—In applying paragraph (2) of subsection (b), a deferred statutory or tort liability loss shall be treated in a manner similar to the manner in which a foreign expropriation loss is treated.

"(4) NO CARRYBACK TO TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1984.—No deferred statutory or tort liability loss may be carried back to a taxable year beginning before January 1, 1984, unless such loss may be carried back to such year without regard to subsection (b)(1)(K)."

(3) CONFORMING AMENDMENTS.—

(A) Clause (i) of section 172(b)(1)(A) is amended by striking out "and (J)" and inserting in lieu thereof "(J), and (K)".

(B) Subsections (h) and (j) of section 172 are each amended by striking out "subsection (b)" in the matter preceding paragraph (1) and inserting in lieu thereof "this section".

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to amounts with respect to which a deduction would be allowable under chapter 1 of the Internal Revenue Code of 1954 (determined without regard to such amendments) after—

(A) in the case of amounts to which section 461(h) of such Code (as added by such amendments) applies, the date of the enactment of this Act, and

(B) in the case of amounts to which section 461(i) of such Code (as so added) applies, after March 31, 1984.

(2) SECTION 461(h) TO APPLY IN CERTAIN CASES.—Notwithstanding paragraph (1), section 461(h) of the Internal Revenue Code of 1954 (as added by this section) shall be treated as being in effect to the extent necessary to carry out any amendments made by this section which take effect before section 461(h).

Subtitle H—Provisions Relating to Tax Straddles

SEC. 101. REPEAL OF EXCEPTION FROM STRADDLE RULES FOR STOCK OPTIONS AND CERTAIN STOCK.

(a) REPEAL OF EXCEPTION FOR STOCK OPTIONS.—

(1) IN GENERAL.—Subparagraph (B) of section 1092(d)(2) (relating to special rule for stock options) is amended to read as follows:

"(B) EXCEPTION FOR QUALIFIED COVERED CALL OPTIONS.—The term 'position' shall not include any qualified covered call option."

(2) QUALIFIED COVERED CALL OPTION DEFINED.—Subsection (d) of section 1092 is amended by adding at the end thereof the following new paragraph:

"(6) QUALIFIED COVERED CALL OPTION DEFINED.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'qualified covered call option' means any option granted by the taxpayer to purchase stock held by the taxpayer (or acquired by the taxpayer in connection with the granting of the option) but only if—

"(i) such option is traded on a national securities exchange which is registered with the Securities and Exchange Commission or on a similar exchange which the Secretary determines has rules adequate to carry out the purposes of this paragraph,

"(ii) gain or loss with respect to such option is not ordinary income or loss,

"(iii) such option is granted more than 30 days before the day on which the option expires, and

"(iv) such option is not a deep-in-the-money option.

"(B) DEEP-IN-THE-MONEY OPTION.—The term 'deep-in-the-money option' means an option having a strike price lower than the lowest qualified bench mark.

"(C) LOWEST QUALIFIED BENCH MARK.—

"(i) IN GENERAL.—Except as otherwise provided in this subparagraph, the term 'lowest qualified bench mark' means the highest available strike price which is less than the applicable stock price.

"(ii) SPECIAL RULE WHERE OPTION IS FOR PERIOD MORE THAN 90 DAYS AND STRIKE PRICE EXCEEDS $50.—In the case of an option—

"(I) which is granted more than 90 days before the date on which such option expires, and

"(II) with respect to which the strike price is more than $50,

the lowest qualified bench mark is the second highest available strike price which is less than the applicable stock price.

"(iii) LOWEST QUALIFIED BENCH MARK MAY NOT BE LESS THAN 85 PERCENT OF STOCK PRICE.—If (but for this clause) the lowest qualified bench mark would be less than 85 percent of the applicable stock price, the lowest qualified bench mark shall be treated as equal to 85 percent of the applicable stock price.

"(D) STRIKE PRICE.—For purposes of this paragraph, the term 'strike price' means the price at which the option is exercisable.

"(E) APPLICABLE STOCK PRICE.—For purposes of this paragraph, the term 'applicable stock price' means, with respect to any stock for which an option has been granted—

"(i) the closing price of such stock on the most recent day on which such stock was traded before the date on which such option was granted, or

"(ii) the opening price of such stock on the day on which such option was granted, but only if such price is greater than 110 percent of the price determined under clause (i).

"(F) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph. Such regulations may include modifications to the provisions of this paragraph which are appropriate to take account of changes in the practices of option exchanges or to prevent the use of options for tax avoidance purposes."

(b) REPEAL OF EXCEPTION FOR STOCK.—

(1) IN GENERAL.—Paragraph (1) of section 1092(d) (defining personal property) is amended by striking out "(other than stock)".

(2) EXCEPTION WHERE STRADDLE CONSISTS OF HOLDING STOCK.—Subsection (d) of section 1092 is amended by redesignating paragraphs (3), (4), (5), and (6) as paragraphs (4), (5), (6), and (7) respectively, and by inserting after paragraph (2) the following new paragraph:

"(3) EXCEPTION WHERE STRADDLE CONSISTS OF HOLDING STOCK.—

"(A) IN GENERAL.—The term 'straddle' shall not include any offsetting positions which (but for this subparagraph) would be a straddle if all of such positions consist of—

"(i) the holding of stock, or

"(ii) the short sale of stock.

"(B) SPECIAL RULE FOR OFFSETTING POSITION STOCK.—Subparagraph (A) shall not apply in the case of stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder."

(c) TREATMENT OF GAIN OR LOSS WHERE TAXPAYER GRANTOR OF OPTION TO BUY STOCK.—Section 1092 is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) TREATMENT OF GAIN OR LOSS WHERE TAXPAYER GRANTOR OF OPTION TO BUY STOCK.—If—

"(1) the taxpayer holds any stock, and

"(2) at any time while the taxpayer holds such stock, there is outstanding an option granted by the taxpayer to purchase such stock and such option has a strike price less than the applicable stock price, any amount which (but for this subsection) would be treated as long-term capital gain with respect to such stock (or any substituted basis property with respect to such stock) shall be treated as short-term capital gain to the extent of any short-term capital loss recognized on the option."

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to positions established after October 31, 1983, in taxable years ending after such date.

(2) SPECIAL RULE FOR OFFSETTING POSITION STOCK.—In the case of any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder, the amendments made by this section shall apply to positions established on or after May 23, 1983, in taxable years ending on or after such date.

(3) SUBSECTION (c).—The amendment made by subsection (c) shall apply to positions established after March 1, 1984, in taxable years ending after such date.

SEC. 102. SECTION 1256 EXTENDED TO CERTAIN OPTIONS.

(a) GENERAL RULE.—

(1) Section 1256 (relating to regulated futures contracts marked to market) is amended—

(A) by striking out "regulated futures contract" each place it appears and inserting in lieu thereof "section 1256 contract", and

(B) by striking out "regulated futures contracts" each place it appears and inserting in lieu thereof "section 1256 contracts".

(2) Subsection (b) of section 1256 is amended to read as follows:

"(b) SECTION 1256 CONTRACT DEFINED.—For purposes of this section, the term 'section 1256 contract' means—

"(1) any regulated futures contract,

"(2) any foreign currency contract,

"(3) any nonequity option, and

"(4) any dealer equity option."

(3) Subsection (g) of section 1256 is amended to read as follows:

"(g) DEFINITIONS.—For purposes of this section—

"(1) REGULATED FUTURES CONTRACTS DEFINED.—The term 'regulated futures contract' means a contract—

"(A) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and

"(B) which is traded on or subject to the rules of a qualified board or exchange.

"(2) FOREIGN CURRENCY CONTRACT DEFINED.—

"(A) FOREIGN CURRENCY CONTRACT.—The term 'foreign currency contract' means a contract—

"(i) which requires delivery of a foreign currency which is a currency in which positions are also traded through regulated futures contracts,

"(ii) which is traded in the interbank market, and

"(iii) which is entered into at arm's length at a price determined by reference to the price in the interbank market.

"(B) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of subparagraph (A), including regulations excluding from the application of subparagraph (A) any contract (or type of contract) if its application thereto would be inconsistent with such purposes.

"(3) NONEQUITY OPTION.—The term 'nonequity option' means any listed option which is not an equity option.

"(4) DEALER EQUITY OPTION.—The term 'dealer equity option' means, with respect to an options dealer, any listed option which—

"(A) is an equity option,

"(B) is purchased or granted by such options dealer in the normal course of his trade or business, and

"(C) is listed on the national securities exchange on which such options dealer is registered.

"(5) LISTED OPTION.—The term 'listed option' means any option (other than a right to acquire stock from the issuer) which is traded on (or subject to the rules of) a qualified board or exchange.

"(6) EQUITY OPTION.—The term 'equity option' means any option to buy or sell stock. Such term also includes any other option with respect to an index or a group of stocks unless—

"(A) there is in effect a designation by the Commodity Futures Trading Commission of a contract market for a contract based on such index or group of stocks, or

"(B) the Secretary determines that such option meets the requirements of the Commodity Futures Trading Commission in effect for such a designation.

"(7) QUALIFIED BOARD OR EXCHANGE.—The term 'qualified board or exchange' means—

"(A) a national securities exchange which is registered with the Securities and Exchange Commission,

"(B) a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or

"(C) any other exchange or board of trade which the Secretary determines has rules adequate to carry out the purposes of this section.

"(8) OPTIONS DEALER.—The term 'options dealer' means any person registered with the Securities and Exchange Commission and an appropriate national securities exchange as a market maker or specialist in listed options."

(b) CAPITAL GAIN TREATMENT FOR TRADERS IN SECTION 1256 CONTRACTS.—Subsection (f) of section 1256 (relating to special rules) is amended by adding at the end thereof the following new paragraphs:

"(3) CAPITAL GAIN TREATMENT FOR TRADERS IN SECTION 1256 CONTRACTS.—

"(A) IN GENERAL.—For purposes of this title, gain or loss from trading of section 1256 contracts (whether or not such trading is in the ordinary course of the taxpayer's trade or business of trading section 1256 contracts) shall be treated as gain or loss from the sale or exchange of a capital asset.

"(B) EXCEPTION FOR CERTAIN HEDGING TRANSACTIONS.—Subparagraph (A) shall not apply to any section 1256 contract to the extent such contract is held for purposes of hedging property if any gain or loss with respect to such property in the hands of the taxpayer would be ordinary income or loss.

"(C) TREATMENT OF UNDERLYING PROPERTY.—For purposes of determining whether gain or loss with respect to any property is ordinary income or loss, the fact that the taxpayer is in the trade or business of trading section 1256 contracts related to such property shall not be taken into account.

"(4) SUBSECTION (a)(3) NOT TO APPLY TO CERTAIN LIMITED PARTNERS OR LIMITED ENTREPRENEURS.—Paragraph (3) of subsection (a) shall not apply to any gain or loss with respect to dealer equity options which are allocable to limited partners or limited entrepreneurs (within the meaning of subsection (e)(3))."

(c) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Subsection (c) of section 1256 (relating to terminations, etc.) is amended—

(A) by striking out "by taking or making delivery," in paragraph (1) and inserting in lieu thereof "by taking or making delivery, by exercise or being exercised by assignment or being assigned, by lapse,",

(B) by striking out "takes delivery under" in paragraph (2) and inserting in lieu thereof "takes delivery under or exercises", and

(C) by striking out "TAKES DELIVERY ON" in the heading of paragraph (2) and inserting in lieu thereof "TAKES DELIVERY ON OR EXERCISES".

(2) Subsection (d) of section 1092 (as in effect before the amendments made by section 101) is amended by striking out paragraphs (4) and (5) and inserting in lieu thereof the following:

"(4) SPECIAL RULE FOR SECTION 1256 CONTRACTS.—In the case of a straddle at least 1 (but not all) of the positions of which are section 1256 contracts, the provisions of this section shall apply to any section 1256 contract and any other position making up such straddle.

"(5) SECTION 1256 CONTRACT.—The term 'section 1256 contract' has the meaning given such term by section 1256(b)."

(3) Subsection (c) of section 1212 (relating to carryback of losses from regulated futures contracts to offset prior gains from such contracts) is amended—

(A) by striking out "net commodity futures loss" each place it appears (including in any headings) and inserting in lieu thereof "net section 1256 contracts loss",

(B) by striking out "regulated futures contracts" each place it appears (including in any headings) and inserting in lieu thereof "section 1256 contracts", and

(C) by striking out "net commodity futures gain" each place it appears (including in any headings) and inserting in lieu thereof "net section 1256 contract gain".

(4) Paragraph (1) of section 1234A (relating to gains or losses from certain terminations) is amended by striking out "a regulated futures contract" and inserting in lieu thereof "a section 1256 contract".

(5) The section heading for section 1256 is amended by striking out "**REGULATED FUTURES**

CONTRACTS" and inserting in lieu thereof "**SECTION 1256 CONTRACTS**".

(6) The table of sections for part IV of subchapter P of chapter 1 is amended by striking out "Regulated futures contracts" and inserting in lieu thereof "Section 1256 contracts".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection or subsection (e), the amendments made by this section shall apply to positions established after the date of the enactment of this Act, in taxable years ending after such date.

(2) SPECIAL RULE FOR OPTIONS ON REGULATED FUTURES CONTRACTS.—In the case of any option with respect to a regulated futures contract (within the meaning of section 1256 of the Internal Revenue Code of 1954), the amendments made by this section shall apply to positions established after October 31, 1983, in taxable years ending after such date.

(e) ELECTIONS WITH RESPECT TO PROPERTY HELD ON OR BEFORE THE DATE OF THE ENACTMENT OF THIS ACT.—At the election of the taxpayer—

(1) the amendments made by this section shall apply to all section 1256 contracts held by the taxpayer on the date of the enactment of this Act, effective

for periods after such date in taxable years ending after such date, or

(2) in lieu of an election under paragraph (1), the amendments made by this section shall apply to all section 1256 contracts held by the taxpayer at any time during the taxable year of the taxpayer which includes the date of the enactment of this Act.

(f) ELECTION FOR INSTALLMENT PAYMENT OF TAX ATTRIBUTABLE TO STOCK OPTIONS.—

(1) If the taxpayer makes an election under this subsection—

(A) the taxpayer may pay part or all the tax for the taxable year referred to in subsection (e)(2) in 2 or more (but not exceeding 5) equal installments, and

(B) the maximum amount of tax which may be paid in installments under this subsection shall be the excess of—

(i) the tax for such taxable year determined by taking into account subsection (e)(2), over

(ii) the tax for such taxable year determined by taking into account subsection (e)(2) and by treating all section 1256 contracts which are stock options and which were held by the taxpayer on the first day of such taxable year as having been acquired for a purchase price equal to their fair market value on the last business day of the preceding taxable year.

An election under this subsection may be made only if the taxpayer makes an election under subsection (e)(2).

(2) DATE FOR PAYMENT OF INSTALLMENT.—

(A) If an election is made under this subsection, the first installment under paragraph (1) shall be paid on or before the due date for filing the return for the taxable year described in paragraph (1), and each succeeding installment shall be paid on or before the date which is one year after the date prescribed for payment of the preceding installment.

(B) If a bankruptcy case or insolvency proceeding involving the taxpayer is commenced before the final installment is paid, the total amount of any unpaid installments shall be treated as due and payable on the day preceding the day on which such case or proceeding is commenced.

(3) INTEREST IMPOSED.—For purposes of section 6601 of the Internal Revenue Code of 1954, the time for payment of any tax with respect to which an elec-

tion is made under this subsection shall be determined without regard to this subsection.

(4) FORM OF ELECTION.—An election under this subsection shall be made not later than the time for filing the return for the taxable year described in paragraph (1) and shall be made in the manner and form required by regulations prescribed by the Secretary. The election shall set forth—

(A) the amount determined under paragraph (1)(B) and the number of installments elected by the taxpayer,

(B) each section 1256 contract which is a stock option held by the taxpayer on the first day of the taxable year described in paragraph (1), and the date such contract was acquired,

(C) the fair market value on the last business day of the preceding taxable year of every contract described in subparagraph (B), and

(D) such other information for purposes of carrying out the provisions of this subsection as may be required by such regulations.

(g) DEFINITIONS.—For purposes of subsections (e) and (f)—

(1) SECTION 1256 CONTRACT.—The term "section 1256 contract" has the meaning given to such

term by section 1256(b) of the Internal Revenue Code of 1954 (as amended by this section).

(2) Stock option.—The term "stock option" means any option to buy or sell stock.

SEC. 103. REGULATIONS UNDER SECTION 1092(b).

(a) General Rule.—Subsection (b) of section 1092 (relating to character of gain or loss; wash sales) is amended to read as follows:

"(b) Regulations.—The Secretary shall prescribe such regulations with respect to gain or loss on positions which are part of a straddle as may be necessary to carry out the purposes of this section. To the extent consistent with such purposes, such regulations shall include rules applying the principles of subsections (a) and (d) of section 1091 and of subsections (b) and (d) of section 1233."

(b) Requirement That Regulations Be Issued Within 6 Months After the Date of Enactment.—The Secretary of the Treasury or his delegate shall prescribe regulations under section 1092(b) of the Internal Revenue Code of 1954 (including regulations relating to mixed straddles) not later than the date 6 months after the date of the enactment of this Act.

SEC. 104. LIMITATION ON LOSSES FROM HEDGING TRANSACTIONS.

(a) GENERAL RULE.—Subsection (e) of section 1256 (relating to mark to market not to apply to hedging transactions) is amended by adding at the end thereof the following new paragraph:

"(5) LIMITATION ON LOSSES FROM HEDGING TRANSACTIONS.—

"(A) IN GENERAL.—

"(i) LIMITATION.—Any hedging loss for a taxable year shall be allowed only to the extent of the taxable income of the taxpayer for such taxable year attributable to the trade or business in which the hedging transactions were entered into. For purposes of the preceding sentence, taxable income shall be determined by not taking into account items attributable to hedging transactions.

"(ii) CARRYOVER OF DISALLOWED LOSS.—Any hedging loss disallowed under clause (i) shall be treated as a deduction attributable to a hedging transaction allowable in the first succeeding taxable year.

"(B) EXCEPTION WHERE ECONOMIC LOSS.—Subparagraph (A)(i) shall not apply to any hedging loss to the extent that such loss exceeds the aggregate unrecognized gains from hedging transactions as of the close of the taxable year.

"(C) EXCEPTION FOR CERTAIN HEDGING TRANSACTIONS.—In the case of any hedging transaction relating to property other than stock or securities, this section shall only apply in the case of a taxpayer described in section 465(a)(1).

"(D) HEDGING LOSS.—The term 'hedging loss' means the excess of—

"(i) the deductions allowable under this chapter for the taxable year attributable to hedging transactions (determined without regard to subparagraph (A)(i)), over

"(ii) income received or accrued by the taxpayer during such taxable year from such transactions.

"(E) UNRECOGNIZED GAIN.—The term 'unrecognized gain' has the meaning given to such term by section 1092(a)(3)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

SEC. 105. CLARIFICATION THAT SECTION 1234 APPLIES TO CASH SETTLEMENT OPTIONS.

(a) GENERAL RULE.—Section 1234 (relating to options to buy or sell) is amended by adding at the end thereof the following new subsection:

"(c) TREATMENT OF CASH SETTLEMENT OPTIONS.—

"(1) IN GENERAL.—For purposes of subsections (a) and (b), a cash settlement option shall be treated as an option to buy or sell property.

"(2) CASH SETTLEMENT OPTION.—For purposes of paragraph (1), the term 'cash settlement option' means any option which on exercise settles in (or could be settled in) cash or property other than the underlying property."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to options purchased or granted after October 31, 1983, in taxable years ending after such date.

Subtitle I—Employee Benefit Provisions

PART I—WELFARE BENEFIT PLANS

SEC. 111. TREATMENT OF FUNDED WELFARE BENEFIT PLANS.

(a) GENERAL RULE.—Part I of subchapter D of chapter 1 (relating to pension, profit sharing, stock bonus plans, etc.) is amended by adding at the end thereof the following new subpart:

"Subpart D—Treatment of Welfare Benefit Funds

"Sec. 419. Treatment of funded welfare benefit plans.

"SEC. 419. TREATMENT OF FUNDED WELFARE BENEFIT PLANS.

"(a) GENERAL RULE.—Contributions paid or accrued by an employer to a welfare benefit fund—

"(1) shall not be deductible under section 162 or 212, but

"(2) if they satisfy the requirements of either of such sections, shall (subject to the limitation of subsection (b)) be deductible under this section for the taxable year in which paid.

"(b) LIMITATION.—The amount of the deduction allowable under subsection (a)(2) for any taxable year shall not exceed the welfare benefit fund's qualified cost for the taxable year.

"(c) QUALIFIED COST.—For purposes of this section—

"(1) IN GENERAL.—Except as otherwise provided in this subsection, the term 'qualified cost' means, with respect to any taxable year, the sum of—

"(A) the qualified direct cost for such taxable year, and

"(B) subject to the limitation of paragraph (4)(B), any addition to a qualified asset account for the taxable year.

"(2) INCOME ADJUSTMENTS.—In the case of any welfare benefit fund, the qualified cost for any taxable year shall be reduced by such fund's after-tax income for such taxable year.

"(3) QUALIFIED DIRECT COST.—

"(A) IN GENERAL.—The term 'qualified direct cost' means, with respect to any taxable year, the aggregate amount which would have been allowable as a deduction to the employer with respect to the benefits provided during the taxable year, if—

"(i) such benefits were provided directly by the employer, and

"(ii) the employer used the cash receipts and disbursements method of accounting.

"(B) TIME WHEN BENEFITS PROVIDED.—For purposes of subparagraph (A), a benefit shall be treated as provided when such benefit would be includible in the gross income of the employee if provided directly by the employer (or would be so includible but for any provision of this chapter excluding such benefit from gross income).

"(C) ADJUSTMENT TO QUALIFIED DIRECT COST FOR EXCESS CHANGEOVER RESERVE.—

"(i) IN GENERAL.—In the case of a welfare benefit fund with an excess changeover reserve, the qualified direct cost for any taxable year—

"(I) shall be applied against the amount of such reserve, and

"(II) to the extent so applied shall not be taken into account under paragraph (1)(A).

"(ii) EXCESS RESERVE REDUCED NOT MORE RAPIDLY THAN RATABLY OVER 5 TAXABLE YEARS.—Clause (i) shall not apply for any taxable year to the extent that the application of clause (i) to such taxable year and preceding taxable years result in the excess changeover reserve being reduced more rapidly than ratably over the first 5 taxable years ending after March 31, 1984.

"(iii) EXCESS CHANGEOVER RESERVE.—For purposes of this subparagraph, the term 'excess changeover reserve' means the excess of—

"(I) the amount of assets set aside for purposes described in paragraph (4)(A) as of March 31, 1984, over

"(II) the amount which would have been permitted to be set aside under paragraph (4)(B) as of such date.

"(4) QUALIFIED ASSET ACCOUNT.—

"(A) IN GENERAL.—The term 'qualified asset account' means any assets set aside to provide for the payment of welfare benefits, other than facilities used in the provision of such benefits.

"(B) LIMITATION.—The limitation provided by this subparagraph for any taxable year is the amount (if any) which would have to be added to the qualified asset account so that the amount in such account as of the close of the taxable year equals 75 percent of the average annual qualified direct costs (other than insurance premiums) for taxable years in the base period for benefits for which reserves are permitted.

"(C) VALUATION.—For purposes of subparagraph (B), the amount of the qualified asset account shall be the value of the assets in such account (as determined under regulations).

"(D) BASE PERIOD.—The term 'base period' means the period consisting of the taxable year and the preceding taxable year.

"(E) BENEFITS FOR WHICH RESERVES ARE PERMITTED.—The term 'benefits for which reserves are permitted' means any life insurance, accident, sickness, severance pay, supplemental unemployment, or group legal benefits.

"(F) HIGHER LIMITATION IN CERTAIN CASES.—In the case of benefits for which reserves are permitted, the Secretary shall by regulations provide that the amount of the qualified asset account may exceed the limitation of subparagraph (B)—

"(i) if the limitation of subparagraph (B) is less than the amount of claims incurred but unpaid and expected to be paid before the close of the next taxable year, or

"(ii) if the liability for which the account was established is under a collective bargaining agreement and a higher reserve is necessary.

"(5) AFTER-TAX INCOME.—

"(A) IN GENERAL.—The term 'after-tax income' means, with respect to any taxable year, the gross income of the welfare benefit fund reduced by the sum of—

"(i) the deductions allowed by this chapter which are directly connected with the production of such gross income, and

"(ii) the tax imposed by this chapter on the fund for the taxable year.

"(B) TREATMENT OF CERTAIN AMOUNTS.—In determining the gross income of any welfare benefit fund—

"(i) contributions and other amounts received from employees shall be taken into account, but

"(ii) contributions from the employer shall not be taken into account.

"(6) ITEM ONLY TAKEN INTO ACCOUNT ONCE.—No item may be taken into account more than once in determining the qualified cost of any welfare benefit fund.

"(d) CARRYOVER OF EXCESS CONTRIBUTIONS.—If—

"(1) the amount of the contributions paid (or deemed paid under this subsection) by the employer during any taxable year to a welfare benefit fund, exceeds

"(2) the limitation of subsection (b),

such excess shall be treated as an amount paid by the employer to such fund during the succeeding taxable year.

"(e) WELFARE BENEFIT FUND.—For purposes of this section—

"(1) IN GENERAL.—The term 'welfare benefit fund' means any fund—

"(A) which is part of a plan of an employer, and

"(B) through which the employer provides welfare benefits to employees or their beneficiaries.

"(2) WELFARE BENEFIT.—The term 'welfare benefit' means any benefit other than a benefit with respect to which—

"(A) section 83(h) applies,

"(B) section 404 applies (determined without regard to section 404(b)(2)),

"(C) section 404A applies, or

"(D) an election under section 463 applies.

"(3) FUND.—The term 'fund' means—

"(A) any organization described in paragraph (7), (9), (17), or (20) of section 501(c), and

"(B) any trust, corporation, or other organization not exempt from the tax imposed by this chapter.

"(f) METHOD OF CONTRIBUTIONS, ETC., HAVING THE EFFECT OF A PLAN.—If—

"(1) there is no plan, but

"(2) there is a method or arrangement of employer contributions or benefits which has the effect of a plan,

this section shall apply as if there were a plan.

"(g) EXTENSION TO PLANS FOR INDEPENDENT CONTRACTORS.—If any fund would be a welfare benefit fund (as modified by subsection (f)) but for the fact that there is no employee-employer relationship—

"(1) this section shall apply as if there were such plan, and

"(2) any references in this section to the employer shall be treated as a reference to the person for whom services are provided, and any reference in this section to an employee shall be treated as a reference to the person providing the services.

"(h) AGGREGATION RULES.—For purposes of this section—

"(1) AGGREGATION OF FUNDS OF EMPLOYER.—All welfare benefit funds of an employer shall be treated as 1 fund.

"(2) TREATMENT OF RELATED EMPLOYERS.—Rules similar to the rules of subsections (b), (c), (m), and (n) of section 414 shall apply. For purposes of the preceding sentence, section 414(m)(5)(B) shall be applied by substituting ‘section 318’ for ‘section 267(c)’.

“(i) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section. Such regulations may provide that the plan administrator of any welfare benefit fund which is part of a multiemployer plan shall submit such information to the employers contributing to the fund as may be necessary to enable the employers to comply with the provisions of this section.”

(b) CLERICAL AMENDMENT.—The table of subparts for part I of subchapter D of chapter 1 is amended by adding at the end thereof the following new item:

“Subpart D. Treatment of welfare benefit funds.”

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to contributions paid or accrued after March 31, 1984, in taxable years ending after such date.

(2) SPECIAL RULE FOR COLLECTIVE BARGAINING AGREEMENTS.—In the case of a plan maintained pursuant to 1 or more collective bargaining agreements—

(A) between employee representatives and 1 or more employers, and

(B) in effect on March 1, 1984 (or ratified on or before such date),

the amendments made by this section and section 114 shall not apply to years beginning before the later of (i) the date on which the last of the collective bargaining agreements relating to the plan terminates (determined without regard to any extension thereof agreed to after March 1, 1984), or (ii) January 1, 1986.

(3) SPECIAL RULE FOR PARAGRAPH (2).—For purposes of paragraph (2), any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added by this section or section 114 shall not be treated as a termination of such collective bargaining agreement.

SEC 112. TREATMENT OF UNFUNDED DEFERRED BENEFITS.

(a) GENERAL RULE.—Subsection (b) of section 404 (relating to method of contributions, etc., having the effect of a plan) is amended to read as follows:

"(b) METHOD OF CONTRIBUTIONS, ETC., HAVING THE EFFECT OF A PLAN; UNFUNDED DEFERRED BENEFITS.—

"(1) METHOD OF CONTRIBUTIONS, ETC., HAVING THE EFFECT OF A PLAN.—If—

"(A) there is no plan, but

"(B) there is a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation (including a plan described in paragraph (2)),

subsection (a) shall apply as if there were such a plan.

"(2) PLANS PROVIDING UNFUNDED DEFERRED BENEFITS.—

"(A) IN GENERAL.—For purposes of this section, any plan providing for deferred benefits (other than compensation) for employees, their spouses, or their dependents shall be treated as a plan deferring the receipt of compensation. In the case of such a plan, for purposes of this section, the determination of when an amount is includible in gross income shall be made without regard to any provisons of this chapter excluding such benefits from gross income.

"(B) EXCEPTION FOR FUNDED BENEFITS.—Subparagraph (A) shall not apply to any benefit provided through a welfare benefit fund (as defined in section 419(e))."

(b) CROSS REFERENCE.—Subsection (j) of section 162 (relating to cross references) is amended by adding at the end thereof the following new paragraph:

> **"(3) For special rules relating to—**
> **"(A) funded welfare benefit plans, see section 419, and**
> **"(B) deferred compensation and other deferred benefits, see section 404."**

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to amounts paid or incurred after March 31, 1984, in taxable years ending after such date.

SEC. 113. ADDITIONAL REQUIREMENTS FOR TAX-EXEMPT STATUS OF CERTAIN ORGANIZATIONS.

(a) GENERAL RULE.—Part I of subchapter P of chapter 1 (relating to exempt organizations) is amended by adding at the end thereof the following new section:

"SEC. 505. ADDITIONAL REQUIREMENTS FOR ORGANIZATIONS DESCRIBED IN PARAGRAPH (9), (17), OR (20) OF SECTION 501(c).

"(a) CERTAIN REQUIREMENTS MUST BE MET IN THE CASE OF ORGANIZATIONS DESCRIBED IN PARAGRAPH (9), (17), OR (20) OF SECTION 501(c).—

"(1) VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS, ETC.—An organization described in paragraph (9) or (20) of subsection (c) of section 501 which is part of a plan of an employer shall not be exempt from tax under section 501(a) unless such plan meets the requirements of paragraphs (1) and (2) of subsection (b) of this section.

"(2) SUPPLEMENTAL UNEMPLOYMENT COMPENSATION BENEFIT TRUSTS.—A trust described in paragraph (17) of subsection (c) of section 501 shall not be exempt from tax under section 501(a) unless the plan of which such trust is a part meets the requirements of paragraph (1) of subsection (b) of this section.

"(3) EXCEPTION FOR COLLECTIVE BARGAINING AGREEMENTS.—Paragraphs (1) and (2) shall not apply to any organization which is part of a plan maintained pursuant to 1 or more collective bargaining agreements between 1 or more employee organizations and 1 or more employers.

"(b) REQUIREMENTS.—

"(1) UTILIZATION.—A plan meets the requirements of this paragraph with respect to any class of benefits for any year only if the benefits of such class provided under the plan during such year to highly compensated individuals do not exceed 25 percent of the benefits of such class provided under such plan during such year.

"(2) NONDISCRIMINATION REQUIREMENTS.—

"(A) In general.—Except as provided in subparagraph (B), a plan meets the requirements of this paragraph only if—

"(i) each class of benefits under the plan is provided under a classification which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are highly compensated individuals, and

"(ii) in the case of each class of benefits, such benefits do not discriminate in favor of employees who are highly compensated employees.

A life insurance, disability, severance pay, or supplemental unemployment benefit shall not be considered to fail to meet the requirements of clause (ii) merely because the benefits received bears a uniform relationship to the total compensation, or the basic or regular rate of compensation, or employees covered by the plan.

"(B) Application of paragraph where other nondiscrimination rules provided.—In the case of any benefit for which nondiscrimination rules are applicable under a provision of law other than this subsection, the requirements of this paragraph are met only if such rules are satisfied with respect to such benefit.

"(C) AGGREGATION RULES.—Rules similar to the rules of section 419(h) shall apply for purposes of this subsection.

"(3) HIGHLY COMPENSATED INDIVIDUAL.—For purposes of this subsection, the term 'highly compensated individual' has the meaning given such term by section 105(h)(5). For purposes of the preceding sentence, section 105(h)(5) shall be applied by substituting '10 percent' for '25 percent'.

"(c) REQUIREMENT THAT ORGANIZATION NOTIFY SECRETARY THAT IT IS APPLYING FOR TAX-EXEMPT STATUS.—

"(1) IN GENERAL.—An organization shall not be treated as an organization described in paragraph (9), (17), or (20) of section 501(c)—

"(A) unless it has given notice to the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for recognition of such status, or

"(B) for any period before the giving of such notice, if such notice is given after the time prescribed by the Secretary by regulations for giving notice under this subsection.

"(2) SPECIAL RULE FOR EXISTING ORGANIZATIONS.—In the case of any organization in existence on March 31, 1984, the time for giving notice under paragraph (1) shall not expire before the date 1 year after the date of the enactment of this section."

(b) CLERICAL AMENDMENT.—The table of sections for part I of subchapter P of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 505. Additional requirements for organizations described in paragraph (9), (17), or (20) of section 501(c)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984.

SEC. 114. AMENDMENTS TO TAX ON UNRELATED BUSINESS INCOME.

(a) EXTENSION OF SECTION 512(a)(3) TO SUPPLEMENTAL UNEMPLOYMENT BENEFIT AND GROUP LEGAL TRUSTS.—

(1) Paragraph (3) of section 512(a) (relating to special rules applicable to organizations described in section 501(c) (7) or (9)) is amended by striking out "section 501(c) (7) or (9)" each place it appears (including in the paragraph heading) and inserting in lieu thereof "paragraph (7), (9), (17), or (20) of section 501(c)".

(2) Clause (ii) of section 512(a)(3)(B) is amended by striking out "section 501(c)(9)" and inserting in lieu thereof "paragraph (9), (17), or (20) of section 501(c)".

(b) LIMITATION ON DEDUCTION FOR SET-ASIDE.—Paragraph (3) of section 512(a) is amended by adding at the end thereof the following new subparagraph:

"(E) LIMITATION ON AMOUNT OF SET-ASIDE IN THE CASE OF ORGANIZATIONS DESCRIBED IN PARAGRAPH (9), (17), OR (20) OF SECTION 501(C).—

"(i) IN GENERAL.—In the case of any organization described in paragraph (9), (17), or (20) of section 501(c), a set-aside for any purpose specified in clause (ii) of subparagraph (B) may be taken into account under subparagraph (B) only to the extent that such set-aside does not result in an amount of assets set aside for such purpose in excess of the limitation of section 419(c)(4)(B).

"(ii) SPECIAL RULES.—For purposes of clause (i)—

"(I) in the case of any organization which is a member of a group of organizations treated as 1 organization under section 419(h), the limitation of section

419(c)(4)(B) shall be such organization's proportionate share of such limitation determined for such group, and

"(II) assets used in the provision of benefits described in clause (ii) of subparagraph (B) shall not be taken into account."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984.

SEC. 115. EMPLOYER AND EMPLOYEE BENEFIT ASSOCIATION TREATED AS RELATED PERSONS UNDER SECTION 1239.

(a) GENERAL RULE.—Section 1239 (relating to gain from sale of depreciable property between certain related taxpayers) is amended by adding at the end thereof the following new subsection:

"(d) EMPLOYER AND RELATED EMPLOYEE ASSOCIATION.—For purposes of subsection (a), the term 'related person' also includes—

"(1) an employer and any person related to the employer (within the meaning of subsection (b)), and

"(2) an organization described in paragraph (7), (9), (17), or (20) of section 501(c) and which is controlled directly or indirectly by persons referred to in paragraph (1)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to sales or exchanges after December 31, 1984, in taxable years ending after such date.

PART II—OTHER PROVISIONS

SEC. 116. TREATMENT OF CERTAIN MEDICAL, ETC., BENEFITS UNDER SECTION 415.

(a) GENERAL RULE.—Section 415 (relating to limitations on benefits and contributions under qualified plan) is amended by adding at the end thereof the following new subsection:

"(l) TREATMENT OF CERTAIN MEDICAL BENEFITS.—

"(1) IN GENERAL.—For purposes of this section, contributions allocated to any individual medical account which is part of a defined benefit plan shall be treated as an annual addition to a defined contribution plan for purposes of subsection (c).

"(2) INDIVIDUAL MEDICAL BENEFIT ACCOUNT.—For purposes of paragraph (1), the term 'individual medical benefit account' means any separate account—

"(A) which is established for a participant under a defined benefit plan, and

"(B) from which benefits described in section 401(h) are payable solely to such participant, his spouse, or his dependents."

(b) REQUIREMENT THAT SEPARATE ACCOUNT BE MAINTAINED FOR 5-PERCENT OWNER.—Subsection (h) of section 401 (relating to medical, etc., benefits for retired employees and their spouses and dependents) is amended by striking out "and" at the end of paragraph (4), by striking out the period at the end of paragraph (5) and inserting in lieu thereof ", and", and by adding at the end thereof the following new paragraph:

"(6) in the case of an employee who is a 5-percent owner, a separate account is established and maintained for such benefits payable to such employee (and his spouse and dependents) and such benefits (to the extent attributable to plan years beginning after March 31, 1984, for which the employee is a 5-percent owner) are only payable to such employee (and his spouse and dependents) from such separate account.

For purposes of paragraph (6), the term '5-percent owner' means any employee who, at any time during any of the 5 preceding plan years, is a 5-percent owner (as defined in section 416(i)(1)(B))."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to years beginning after March 31, 1984.

SEC. 117. LIMITATION ON ACCRUAL OF VACATION PAY.

(a) GENERAL RULE.—Paragraph (1) of section 463(a) (relating to annual vacation pay) is amended by striking out "and payable during" and inserting in lieu thereof "and expected to be paid during".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after March 31, 1984.

SEC. 118. DETERMINATION OF WHETHER THERE IS A COLLECTIVE BARGAINING AGREEMENT.

(a) GENERAL RULE.—Subsection (a) of section 7701 (relating to definitions) is amended by adding at the end thereof the following new paragraph:

"(46) DETERMINATION OF WHETHER THERE IS A COLLECTIVE BARGAINING AGREEMENT.—In determining whether there is a collective bargaining agreement between employee representatives and 1 or more employers, the term 'employee representatives' shall not include any organization more than one-half of the members of which are employees who are owners, officers, or executives of the employer."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on April 1, 1984.

SEC. 119. DISQUALIFICATION OF PLAN WHERE SUBSTANTIALLY ALL CONTRIBUTIONS ARE EMPLOYEE CONTRIBUTIONS.

(a) GENERAL RULE.—Subsection (a) of section 401 (relating to qualified pension, profit-sharing, and stock bonus plans) is amended by inserting after paragraph (24) the following new paragraph:

"(25) A trust shall not constitute a qualified trust under this section if substantially all of the accrued benefits under the plan of which such trust is a part are derived from employee contributions."

(b) TECHNICAL AMENDMENTS.—

(1) Paragraph (2) of section 402(a) (relating to certain employees' annuities) is amended by striking out "and (22)" and inserting in lieu thereof "(22), and (25)".

(2) Paragraph (3) of section 818(a) (defining pension plan contracts), as amended by title II of this Act, is amended by striking out "and (22)" and inserting "(22), and (25)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to plan years beginning after March 31, 1984.

SEC. 120. PARTICIPATION AND DISCRIMINATION STANDARDS APPLICABLE TO CASH OR DEFERRED ARRANGEMENTS.

(a) GENERAL RULE.—Subparagraph (A) of section 401(k)(3) is amended to read as follows:

"(A) A qualified cash or deferred arrangement shall be considered to satisfy the requirements of subsection (a)(4), with respect to contributions, and of subparagraph (B) of section 410(b)(1) for a plan year, if (and only if)—

"(i) those employees eligible to participate under the plan satisfy the provisions of subparagraph (A) or (B) of section 410(b)(1), and

"(ii) the actual deferral percentage for highly compensated employees (as defined in paragraph (4)) for such year bears a relationship to the actual deferral percentage for all other eligible employees for such plan year which meets either of the following tests:

"(I) The actual deferral percentage for the group of highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 1.5.

"(II) The excess of the actual deferral percentage for the group of highly compensated employees over that of all other eligible employees is not more than 3 percentage points, and the actual deferral percentage for the group of highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 2.5."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to plan years beginning after December 31, 1984.

Subtitle J—Foreign Provisions

SEC. 131. TREATMENT OF RELATED PERSON FACTORING INCOME.

(a) TREATMENT AS FOREIGN PERSONAL HOLDING COMPANY INCOME.—

(1) IN GENERAL.—Subsection (a) of section 553 (defining foreign personal holding company income) is amended by adding at the end thereof the following new paragraph:

"(8) INCOME FROM TRADE OR SERVICE RECEIVABLES OF RELATED PERSONS.—

"(A) In general.—Income from a trade or service receivable of a related person.

"(B) Trade or service receivable.—For purposes of subparagraph (A), the term 'trade or service receivable' means any account receivable or evidence of indebtedness arising out of the disposition of property described in section 1221(1), or the performance of services, by a related person.

"(C) Related person.—For purposes of this paragraph, the term 'related person' has the meaning given to such term by section 954(d)(3)."

(2) Exception for trade or service receivables of certain foreign corporations.—Subparagraph (A) of section 954(c)(4) (relating to certain income received from related persons) is amended by inserting before the semicolon at the end thereof the following: "or income from a trade or service receivable (as defined in section 553(a)(8)(B)) of such a related person".

(b) Treatment of United States Property.—Subsection (b) of section 956 (defining United States property) is amended by adding at the end thereof the following new paragraph:

"(3) TRADE OR SERVICE RECEIVABLES OF RELATED UNITED STATES PERSONS.—Notwithstanding paragraph (2), the term 'United States property' includes any trade or service receivable (as defined in section 553(a)(8)(B)) of a related person (within the meaning of section 954(d)(3)) who is a United States person."

(c) SOURCE RULE.—Section 861 (relating to income from sources within the United States) is amended by adding at the end thereof the following new subsection:

"(g) INCOME FROM TRADE OR SERVICE RECEIVABLES OF RELATED UNITED STATES PERSONS.—

"(1) IN GENERAL.—For purposes of subsection (a) and section 862(a)—

"(A) income from a trade or service receivable of a related United States person shall be treated as income from sources within the United States, and

"(B) any distribution from a foreign corporation (and any amount included in gross income under section 951) to the extent attributable to income described in subparagraph (A) shall be treated as income from sources within the United States.

"(2) DEFINITIONS.— For purposes of this subsection—

"(A) TRADE OR SERVICE RECEIVABLE.— The term 'trade or service receivable' has the meaning given to such term by section 553(a)(8)(B).

"(B) RELATED UNITED STATES PERSON.— The term 'related United States person' means any related person (within the meaning of section 954(d)(3)) who is a United States person."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984 in taxable years ending after such date.

SEC. 132. TAXATION OF CERTAIN TRANSFERS OF PROPERTY OUTSIDE THE UNITED STATES.

(a) IN GENERAL.—Subsection (a) of section 367 (relating to transfers of property from the United States) is amended to read as follows:

"(a) TRANSFERS OF PROPERTY FROM THE UNITED STATES.—

"(1) GENERAL RULE.—If, in connection with any exchange described in section 332, 351, 354, 355, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.

"(2) EXCEPTION FOR CERTAIN STOCK OR SECURITIES.—Except to the extent provided in regulations, paragraph (1) shall not apply to the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization.

"(3) EXCEPTION FOR TRANSFERS OF CERTAIN PROPERTY USED IN THE ACTIVE CONDUCT OF A TRADE OR BUSINESS.—

"(A) IN GENERAL.—Except as provided in regulations prescribed by the Secretary, paragraph (1) shall not apply to any property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States.

"(B) PARAGRAPH NOT TO APPLY TO CERTAIN PROPERTY.—Except as provided in regulations prescribed by the Secretary, subparagraph (A) shall not apply to any—

"(i) property described in paragraph (1) or (3) of section 1221 (relating to inventory and copyrights, etc.), "(ii) installment obligation, accounts receivable, or similar property,

"(iii) foreign currency or other property denominated in foreign currency, or

"(iv) property with respect to which the transferor is a lessor at the time of the transfer, except that this clause shall not apply if the transferee was the lessee.

"(C) TRANSFER OF FOREIGN BRANCH WITH PREVIOUSLY DEDUCTED LOSSES.—Except as provided in regulations prescribed by the Secretary, subparagraph (A) shall not apply to gain realized on the transfer of the assets of a foreign branch of a United States person to a foreign corporation in an exchange described in paragraph (1) to the extent that—

"(i) the sum of losses—

"(I) which were incurred by the foreign branch before the transfer, and

"(II) with respect to which a deduction was allowed to the taxpayer,

exceeds

"(ii) the amount of such losses which is treated as income from sources within the United States under section 904(f).

Any excess described in the preceding sentence shall be treated for purposes of this chapter as ordinary income from sources outside the United States.

"(4) SPECIAL RULE FOR TRANSFER OF PARTNERSHIP INTERESTS.—Except as provided in regulations prescribed by the Secretary, a transfer by a United States person of an interest in a partnership to a foreign corporation in an exchange described in paragraph (1) shall, for purposes of this subsection, be treated as a transfer to such corporation of such person's pro rata share of the assets of the partnership.

"(5) SECRETARY MAY EXEMPT CERTAIN TRANSACTIONS FROM APPLICATION OF THIS SUBSECTION.—Paragraph (1) shall not apply to the tranfer of any property which the Secretary, in order to carry out the purposes of this subsection, designates by regulation."

(b) SPECIAL RULES FOR TRANSFERS OF INTANGIBLES.—Subsection (d) of section 367 (relating to special rule for transfer of intangibles by possession corporations) is amended to read as follows:

"(d) SPECIAL RULES RELATING TO TRANFERS OF INTANGIBLES.—

"(1) IN GENERAL.—Except as provided in regulations prescribed by the Secretary, if a United States person tranfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 332, 351, 354, 355, 356, or 361—

"(A) subsection (a) shall not apply to the transfer of such property, and

"(B) the provisions of this subsection shall apply to such tranfer.

"(2) TRANSFER OF INTANGIBLES TREATED AS TRANSFER PURSUANT TO EXCLUSIVE LICENSING AGREEMENT.—

"(A) IN GENERAL.—If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as receiving over the useful life of such property amounts which reasonably reflect the amounts which would have been received annually under an exclusive licensing agreement.

"(B) EFFECTIVE ON EARNINGS AND PROFITS.—For purposes of this chapter, the earnings and profits of a foreign corporation to which the intangible property was transferred shall be reduced by the amount of income required to be included in income under subparagraph (A).

"(C) AMOUNTS RECEIVED TREATED AS UNITED STATES SOURCE ORDINARY INCOME.—For purposes of this chapter, any amount included in gross income by reason of this subsection shall be treated as ordinary income from sources within the United States."

(c) SECRETARY MUST BE NOTIFIED OF TRANSACTIONS TO WHICH SECTION 367(a) APPLIES.—

(1) NOTIFICATION REQUIREMENT.—Subpart A of part III of subchapter A of chapter 61 is amended by adding after section 6038A the following new section:

"SEC. 6038B. NOTICE OF TRANSFERS TO WHICH SECTION 367(a) APPLIES.

"(a) IN GENERAL.—Each United States person who transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 355, 356, or 361 shall furnish to the Secretary, at such time and in such manner as the Secretary shall by regulations prescribe, such information with respect to such exchange as the Secretary may require in such regulations.

"(b) PENALTY FOR FAILURE TO FURNISH INFORMATION.—

"(1) IN GENERAL.—If any United States person fails to furnish the information described in subsection (a), such person shall pay a penalty equal to 25 percent of the amount of the gain which would be realized on the exchange if section 367(a) were applicable to such exchange.

"(2) REASONABLE CAUSE EXCEPTION.—Paragraph (1) shall not apply to any failure if the United States person shows such failure is due to reasonable cause and not to willful neglect."

(2) EXTENSION OF PERIOD FOR ASSESSMENT AND COLLECTION WHERE SECRETARY NOT NOTIFIED.—Subsection (c) of section 6501 (relating to exceptions to limitations on assessment and collection) is amended by adding at the end thereof the following new paragraph:

"(8) FAILURE TO NOTIFY SECRETARY UNDER SECTION 6038B.—In the case of any tax imposed on any exchange by reason of section 367(a), the time for assessment of such tax shall not expire before the date which is 3 years after the date on which the Secretary is notified of such exchange under section 6038B(a)."

(3) CONFORMING AMENDMENT.—The table of sections for subpart A of part III of subchapter A of

chapter 61 is amended by adding after the item relating to section 6038A the following new item:

"Sec. 6038B. Notice of transfers to which section 367(a) applies."

(d) REPEAL OF DECLARATORY JUDGMENT PROVISIONS INVOLVING TRANSFERS OF PROPERTY FROM THE UNITED STATES.—

(1) IN GENERAL.—Section 7477 is hereby repealed.

(2) CONFORMING AMENDMENTS.—

(A) Section 7482(b)(1) (relating to venue for review of Tax Court decisions) is amended by striking out subparagraph (D) and by redesignating subparagraphs (E) and (F) as subparagraphs (D) and (E), respectively.

(B) The table of sections for part IV of subchapter C of chapter 76 is amended by striking out the item relating to section 7477.

(e) TRANSFERS TO AVOID INCOME TAX.—

(1) IN GENERAL.—Section 1492 (relating to nontaxable transfers) is amended—

(A) by striking out paragraphs (2) and (3) and by inserting in lieu thereof—

"(2) To a transfer—

"(A) described in section 367, or

"(B) not described in section 367 but with respect to which the taxpayer establishes to the satisfaction of the Secretary that no gain should be recognized under principles similar to the principles of section 367, or", and

(B) by redesignating paragraph (4) as paragraph (3).

(2) CONFORMING AMENDMENT.—Section 1494(b) (relating to abatement or refund) is amended by striking out all that follows "that" and inserting in lieu thereof "no gain should be recognized on such transfer under principles similar to the principles of section 367".

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to transfers or exchanges after December 31, 1984, in taxable years ending after such date.

SEC. 133. SECTION 1248 TO APPLY TO CERTAIN INDIRECT TRANSFERS OF STOCK IN A FOREIGN CORPORATION.

(a) GENERAL RULE.—Section 1248 (relating to gain from certain sales or exchanges of stock in foreign corporations) is amended by adding at the end thereof the following new subsection:

"(i) TREATMENT OF CERTAIN INDIRECT TRANSFERS.—

"(1) IN GENERAL.—If any shareholder of a 10-percent corporate shareholder of a foreign corporation exchanges stock of the 10-percent corporate shareholder for stock of the foreign corporation, for purposes of this section, the stock of the foreign corporation received in such exchange shall be treated as if it had been—

"(A) issued to the 10-percent corporate shareholder, and

"(B) then distributed by the 10-percent corporate shareholder to such shareholder in redemption of his stock.

"(2) 10-PERCENT CORPORATE SHAREHOLDER DEFINED.—For purposes of this subsection, the term '10-percent corporate shareholder' means any domestic corporation which, as of the day before the exchange referred to in paragraph (1), satisfies the stock ownership requirements of subsection (a)(2) with respect to the foreign corporation."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to exchanges after the date of the enactment of this Act in taxable years ending after such date.

SEC. 134. TREATMENT OF UNITED STATES SOURCE ORIGINAL ISSUE DISCOUNT IN CASE OF FOREIGN PERSONS.

(a) NONRESIDENT ALIEN INDIVIDUALS.—

(1) IN GENERAL.—Subparagraph (C) of section 871(a)(1) (relating to income not connected with United States business) is amended to read as follows:

"(C) in the case of—

"(i) a sale or exchange (or retirement) of an original issue discount obligation, the amount of any gain not in excess of the original issue discount accruing while such obligation was held by the nonresident alien individual (to the extent such discount was not theretofore taken into account under clause (ii)), and

"(ii) the payment of interest on an original issue discount obligation, an amount equal to the original issue discount accrued on such obligation since the last payment of interest thereon (except that such original issue discount shall be taken into account under this clause only to the extent that the tax thereon does not exceed the interest payment less the tax imposed by subparagraph (A) thereon), and ".

(2) DEFINITIONS AND SPECIAL RULES.—Section 871 is amended by redesignating subsection (g) as sub-

section (h) and by inserting after subsection (f) the following new subsection:

"(g) SPECIAL RULES FOR ORIGINAL ISSUE DISCOUNT.—For purposes of this section and section 881—

"(1) ORIGINAL ISSUE DISCOUNT OBLIGATION.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'original issue discount obligation' means any bond or other evidence of indebtedness having original issue discount (within the meaning of section 1273).

"(B) EXCEPTIONS.—The term 'original issue discount obligation' shall not include—

"(i) CERTAIN SHORT-TERM OBLIGATIONS.—Any obligation payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer).

"(ii) TAX-EXEMPT OBLIGATIONS.—Any obligation the interest on which is exempt from tax under section 103 or under any other provision of law without regard to the identify of the holder.

"(2) DETERMINATION OF PORTION OF ORIGINAL ISSUE DISCOUNT ACCRUING DURING ANY PERIOD.—The determination of the amount of the original issue discount which accrues during any period shall be made under the rules of section 1272 (or the corresponding provisions of prior law).

"(3) SOURCE OF ORIGINAL ISSUE DISCOUNT.—Except to the extent provided in regulations prescribed by the Secretary, the determination of whether any amount described in subsection (a)(1)(C) is from sources within the United States shall be made at the time of the payment (or sale or exchange) as if such payment (or sale or exchange) involved the payment of interest.

"(4) STRIPPED BONDS.—The provisions of section 1286 (relating to the treatment of stripped bonds and stripped coupons as obligations with original issue discount) shall apply for purposes of this section."

(b) FOREIGN CORPORATIONS.—

(1) IN GENERAL.—Paragraph (3) of section 881(a) (relating to tax on income of foreign corporations not connected with United States business) is amended to read as follows:

"(3) in the case of—

"(A) a sale or exchange (or retirement) of an original issue discount obligation, the amount of any gain not in excess of the original issue discount accruing while such obligation was held by the foreign corporation (to the extent such discount was not theretofore taken into account under subparagraph (B)), and

"(B) the payment of interest on an original issue discount obligation, an amount equal to the original issue discount accrued on such obligation since the last payment of interest thereon (except that such original issue discount shall be taken into account under this subparagraph only to the extent that the tax thereon does not exceed the interest payment less the tax imposed by paragraph (1) thereon), and".

(2) CROSS REFERENCE.—Subsection (c) of section 881 (relating to doubling of tax) is amended to read as follows:

"(c) CROSS REFERENCES.—

"For doubling of tax on corporations of certain foreign countries, see section 891.

"For special rules for original issue discount, see section 871(g)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to the payments made on or after the 60th day after the date of the enactment of this Act with respect to obligations issued after March 31, 1972.

SEC. 135. CLARIFICATION OF DEFINITION OF ARTICLES PRODUCED IN PUERTO RICO OR THE VIRGIN ISLANDS.

(a) GENERAL RULE.—Section 7652 (relating to shipments to the United States) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) ARTICLES PRODUCED IN PUERTO RICO OR THE VIRGIN ISLANDS.—For purposes of subsections (a)(3) and (b)(3)—

"(1) DISTILLED SPIRITS BROUGHT INTO THE UNITED STATES.—Any article containing distilled spirits shall in no event be treated as produced in Puerto Rico or the Virgin Islands unless at least 90 percent of the distilled spirits in such article are attributable to distilled spirits originally distilled in Puerto Rico or the Virgin Islands (as the case may be).

"(2) VALUE ADDED REQUIREMENT FOR PUERTO RICO.—Any article (including distilled spirits) shall in no event be treated as produced in Puerto Rico unless—

"(A) the sum of (i) the cost or value of the materials produced in Puerto Rico, plus (ii) the direct costs of processing operations performed in Puerto Rico, equals or exceeds, "(B) 50 percent of the value of such article as of the time it is brought into the United States.

"(3) PROHIBITION OF FEDERAL EXCISE TAX SUBSIDIES.—

"(A) IN GENERAL.—No amount shall be transferred under subsection (a)(3) or (b)(3) in respect of taxes imposed on any article if the Secretary determines that a Federal excise tax subsidy was provided by Puerto Rico or the Virgin Islands (as the case may be) with respect to such article.

"(B) FEDERAL EXCISE TAX SUBSIDY.—For purposes of this paragraph, the term 'Federal excise tax subsidy' means any subsidy—

"(i) of a kind different from, or

"(ii) in an amount per value or volume of production greater than,

the subsidy which Puerto Rico or the Virgin Islands offers generally to industries producing articles not subject to Federal excise taxes.

"(4) DIRECT COSTS OF PROCESSING OPERATIONS.—For purposes of this subsection, the term 'direct costs of processing operations' has the same meaning as when used in section 213 of the Caribbean Basin Economic Recovery Act.

"(5) Exceptions.—

"(A) In general.—This subsection shall not apply—

"(i) to rum (as defined in subsection (d)(3)), and

"(ii) to any article consumed in Puerto Rico or the Virgin Islands (as the case may be).

"(B) Cane neutral spirits.—Paragraphs (2) and (3) shall not apply to any distilled spirits with a proof of 190 or more which are derived from cane. The preceding sentence shall not apply if the Secretary determines that an arrangement similar to redistillation applies to distilled spirits described in the preceding sentence."

(b) Effective Dates.—

(1) In general.—Except as provided in paragraph (2), the amendment made by subsection (a) shall apply with respect to articles brought into the United States on or after March 1, 1984.

(2) Exception for Puerto Rico for periods before July 1, 1985.—

(A) In general.—Subject to the limitations of subparagraphs (B) and (C), the amendment made by subsection (a) shall not apply with respect to articles brought into the United States from Puerto Rico after February 29, 1984, and before July 1, 1985.

(B) $130,000,000 LIMITATION FOR FISCAL YEAR 1984.—In the case of articles brought into the United States after February 29, 1984, and before July 1, 1984, the aggregate amount payable to Puerto Rico by reason of subparagraph (A) shall not exceed the excess of—

(i) $130,000,000, over,

(ii) the aggregate amount payable to Puerto Rico under section 7652(a) of the Internal Revenue Code of 1954 with respect to articles which were brought into the United States after June 30, 1983, and before March 1, 1984, and which would not meet the requirements of section 7652(c)(1) of such Code.

(C) $75,000,000 LIMITATION FOR FISCAL YEAR 1985.—In the case of articles brought into the United States after June 30, 1984, and before July 1, 1985, the aggregate amount payable to Puerto Rico by reason of subparagraph (A) shall not exceed $75,000,000.

SEC. 136. TREATMENT OF CERTAIN TRANSPORTATION INCOME.

(a) GENERAL RULE.—Section 863 (relating to items not specified in section 861 or 862) is amended by adding at the end thereof the following new subsection:

"(c) SOURCE RULE FOR CERTAIN TRANSPORTATION INCOME.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary, all transportation income attributable to transportation which begins and ends in the United States (or in any possession of the United States) shall be treated as derived from sources within the United States.

"(2) TRANSPORTATION INCOME.—For purposes of this subsection, the term 'transportation income' means any income derived from, or in connection with—

"(A) the use (or hiring or leasing for use) of a vessel or aircraft, or

"(B) the performance of services directly related to the use of a vessel or aircraft.

For purposes of the preceding sentence, the term 'vessel or aircraft' includes any container used in connection with a vessel or aircraft."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to transportation beginning after the date of the enactment of this Act in taxable years ending after such date.

SEC. 137. TREATMENT OF PAYMENTS TO GUAM AND VIRGIN ISLANDS CORPORATIONS.

(a) GENERAL RULE.—Subsection (b) of section 881 (relating to exception for Guam corporations) is amended to read as follows:

"(b) EXCEPTION FOR CERTAIN GUAM AND VIRGIN ISLANDS CORPORATIONS.—

"(1) IN GENERAL.—For purposes of this section, the term 'foreign corporation' does not include a corporation created or organized in Guam or the Virgin Islands or under the law of Guam or the Virgin Islands if—

"(A) 75 percent or more in value of the stock of such corporation is owned (directly or indirectly) by individuals who are citizens or residents of the United States or of any possession of the United States, and

"(B) 75 percent or more of the gross income of the corporation is derived from sources within a possession of the United States.

"(2) PARAGRAPH (1) NOT TO APPLY TO TAX IMPOSED IN GUAM.—For purposes of applying this subsection with respect to income tax liability incurred to Guam pursuant to this title—

"(A) paragraph (1) shall not apply, and

"(B) for purposes of this section, the term 'foreign corporation' does not include a corporation created or organized in Guam or under the law of Guam.

"(3) CROSS REFERENCE.—For tax imposed in the Virgin Islands, see sections 934 and 934A."

(b) TECHNICAL AMENDMENT.—Subparagraph (B) of section 7651(5) is amended by inserting "(other than section 881(b)(1))" after "For purposes of this title".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to payments made after March 1, 1984, in taxable years ending after such date.

SEC. 138. APPLICATION OF COLLAPSIBLE CORPORATION RULES TO FOREIGN CORPORATIONS.

(a) IN GENERAL.—Subsection (f) of section 341 (relating to collapsible corporations) is amended by adding at the end thereof the following new paragraph:

"(8) SPECIAL RULE FOR FOREIGN CORPORATIONS.—To the extent provided in regulations prescribed by the Secretary—

"(A) paragraph (1) shall not apply to a foreign corporation, and

"(B) paragraph (3) shall not apply if the transferee is a foreign corporation."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of enactment of this Act.

SEC. 139. DEFINITION OF FOREIGN INVESTMENT COMPANY.

(a) GENERAL RULE.—Paragraph (2) of section 1246(b) (defining foreign investment company) is amended to read as follows:

"(2) engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in—

"(A) securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended),

"(B) commodities, or

"(C) any interest (including a futures or forward contract or option) in property described in subparagraph (A) or (B),

at a time when 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, was held directly (or indirectly through applying paragraphs (2) and (3) of section 958(a) and paragraph (4) of section

318(a)) by United States persons (as defined in section 7701(a)(30))."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendment made by subsection (a) shall apply to sales and exchanges (and distributions) on or after September 29, 1983, in taxable years ending on or after such date.

(2) STOCK HELD ON SEPTEMBER 29, 1983.—In the case of a sale or exchange (or distribution) not later than the date which is 1 year after the date of the enactment of this Act, the amendment made by subsection (a) shall not apply with respect to stock held by the taxpayer continuously from September 29, 1983, to the date of such sale or exchange (or distribution).

SEC. 140. TREATMENT OF CERTAIN DISTRIBUTIONS RECEIVED BY UNITED STATES-OWNED FOREIGN CORPORATIONS.

(a) GENERAL RULE.—Section 535 (defining accumulated taxable income) is amended by adding at the end thereof the following new subsection:

"(d) INCOME DISTRIBUTED TO UNITED STATES-OWNED FOREIGN CORPORATION RETAINS UNITED STATES CONNECTION.—

"(1) IN GENERAL.—For purposes of this part, if more than 10 percent of the earnings and profits of any foreign corporation for any taxable year—

"(A) is derived from sources within the United States, or

"(B) is effectively connected with the conduct of a trade or business within the United States,

any distribution out of such earnings and profits (and any interest payment) received (directly or through 1 or more other entities) by a United States-owned foreign corporation shall be treated as derived by such corporation from sources within the United States.

"(2) UNITED STATES-OWNED FOREIGN CORPORATION.—For purposes of paragraph (1), the term 'United States-owned foreign corporation' means any foreign corporation if 50 percent or more of—

"(A) the total combined voting power of all classes of stock of such corporation entitled to vote, or

"(B) the total value of all classes of stock of such corporation is held directly (or indirectly through applying paragraphs (2) and (3) of section 958(a) and paragraph (4) of section 318(a)) by

United States persons (as defined in section 7701(a)(30)).”

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendment made by subsection (a) shall apply to distributions received by a United States-owned foreign corporation (within the meaning of section 535(d) of the Internal Revenue Code of 1954) on or after May 23, 1983, in taxable years ending on or after such date.

(2) CORPORATIONS IN EXISTENCE ON MAY 23, 1983.—In the case of a United States-owned foreign corporation (as so defined) in existence on May 23, 1983, the amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

SEC. 141. INTEREST AND DIVIDENDS PAID BY CERTAIN UNITED STATES-OWNED FOREIGN CORPORATIONS TREATED AS DERIVED FROM UNITED STATES SOURCES.

(a) IN GENERAL.—Section 904 (relating to limitation on foreign tax credit) is amended by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection:

"(h) INTEREST AND DIVIDENDS FROM CERTAIN UNITED STATES-OWNED FOREIGN CORPORATIONS TREATED AS DERIVED FROM UNITED STATES SOURCES.—

"(1) IN GENERAL.—For purposes of this section, if 10 percent or more of the gross income of any United States-owned foreign corporation for the 3 taxable years preceding the taxable year in which any distribution or interest payment is made by such corporation (or for such part of such period as the corporation is in existence)—

"(A) is derived from sources within the United States, or

"(B) is effectively connected with the conduct of a trade or business within the United States,

then such distribution (or interest payment) to the extent attributable to gross income described in subparagraph (A) or (B) shall be treated as derived from sources within the United States.

"(2) UNITED STATES-OWNED FOREIGN CORPORATION.—For purposes of paragraph (1), the term 'United States-owned foreign corporation' has the meaning given such term by paragraph (2) of section 535(d).

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendment made by subsection (a) shall apply to any distribution or interest payment made by a United States-owned foreign corporation after the date of the enactment of this Act to the extent attributable to income received or accrued by such corporation after such date.

(2) INTEREST ON OBLIGATIONS HELD ON MARCH 1, 1984, NOT TAKEN INTO ACCOUNT.—The amendment made by subsection (a) shall not apply to interest on any term obligation held by a United States-owned foreign corporation if such corporation held such obligation on March 1, 1984.

SEC. 142. CERTAIN DIVIDENDS TREATED AS INTEREST FOR PURPOSES OF THE LIMITATION ON THE FOREIGN TAX CREDIT.

(a) IN GENERAL.—Subsection (d) of section 904 (relating to limitation on foreign tax credit) is amended by adding at the end thereof the following new paragraph:

"(3) CERTAIN DISTRIBUTIONS OF UNITED STATES-OWNED CORPORATIONS TREATED AS INTEREST.—

"(A) IN GENERAL.—If 10 percent or more of the earnings and profits of a corporation to which this paragraph applies for the 3 taxable years preceding the taxable year during which a distribution is made by such corporation (or for such part of such period as the corporation is in existence) is attributable to interest described in paragraph (2), such distribution (to the extent attributable to such interest), whether made directly or through 1 or more entities, shall be treated as interest described in such paragraph.

"(B) CORPORATIONS TO WHICH PARAGRAPH APPLIES.—This paragraph shall apply to—

"(i) any United States-owned foreign corporation (within the meaning of section 535(d)(2)), and

"(ii) any United States-owned regulated investment company.

For purposes of this paragraph, the determination of whether a regulated investment company is United States-owned shall be determined under the principles of section 535(d)(2).

"(C) CERTAIN AMOUNTS TREATED AS INTEREST.—Subparagraph (C) of paragraph (2) shall not apply to any amount treated as interest under subparagraph (A)."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to distributions made after the date of the enactment of this Act.

(2) INTEREST ON OBLIGATIONS HELD ON MARCH 1, 1984, NOT TAKEN INTO ACCOUNT.—The amendment made by subsection (a) shall not apply to interest on any term obligation held by a United States-owned corporation if such corporation held such obligation on March 1, 1984.

Subtitle K—Reporting, Penalty, and Other Provisions

SEC. 151. ORGANIZERS AND SELLERS OF POTENTIALLY ABUSIVE TAX SHELTERS MUST KEEP LISTS OF INVESTORS.

(a) IN GENERAL.—Subchapter B of chapter 61 (relating to miscellaneous provisions involving information and returns) is amended by redesignating section 6111 as section 6112 and by inserting after section 6110 the following new section:

"SEC. 6111. ORGANIZERS AND SELLERS OF POTENTIALLY ABUSIVE TAX SHELTERS MUST KEEP LISTS OF INVESTORS.

"(a) IN GENERAL.—Any person who—

"(1) organizes any potentially abusive tax shelter, or

"(2) sells any interest in such a shelter,

shall maintain (in such manner as the Secretary may by regulations prescribe) a list identifying each person who was sold an interest in such shelter and containing such other information as the Secretary may by regulations require.

"(b) POTENTIALLY ABUSIVE TAX SHELTER.—For purposes of this section, the term 'potentially abusive tax shelter' means any entity, investment plan or arrangement, or other plan or arrangement which is of a type which the Secretary determines by regulations as having a potential for tax avoidance or evasion.

"(c) SPECIAL RULES.—

"(1) AVAILABILITY FOR INSPECTION; RETENTION OF INFORMATION ON LIST.—Any person who is required to maintain a list under subsection (a)—

"(A) shall make such list available to the Secretary for inspection upon request by the Secretary, and

"(B) except as otherwise provided under regulations prescribed by the Secretary, shall retain any information which is required to be included on such list for 7 years.

"(2) LISTS WHICH WOULD BE REQUIRED TO BE MAINTAINED BY 2 OR MORE PERSONS.—The Secretary shall prescribe regulations which provide that, in cases in which 2 or more persons are required under subsection (a) to maintain the same list (or portion thereof), only 1 person shall be required to maintain such list (or portion)."

(b) PENALTY FOR FAILURE TO MAINTAIN LIST.—Subchapter B of chapter 68 (relating to assessable penalties) is amended by adding at the end thereof the following new section:

"SEC. 6706. FAILURE TO MAINTAIN LISTS OF INVESTORS IN POTENTIALLY ABUSIVE TAX SHELTERS.

"(a) IN GENERAL.—Any person who fails to meet any requirement imposed by section 6111 shall pay a penalty of $50 for each person with respect to whom there is such a failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection for any calendar year shall not exceed $50,000.

"(b) PENALTY IN ADDITION TO OTHER PENALTIES.—The penalty imposed by this section shall be in addition to any other penalty provided by law."

(c) CONFORMING AMENDMENTS.—

(1) The table of sections for subchapter B of chapter 61 is amended by striking out the item relating to section 6111 and inserting in lieu thereof the following new items:

"Sec. 6111. Organizers and sellers of potentially abusive tax shel-

ters must keep lists of investors.
"Sec. 6112. Cross reference."

(2) The table of sections for subchapter B of chapter 68 is amended by adding at the end thereof the following new item:

"Sec. 6706. Failure to maintain lists of investors in potentially abusive tax shelters."

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

SEC. 152. RETURNS RELATING TO MORTGAGE INTEREST RECEIVED IN TRADE OR BUSINESS.

(a) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by adding at the end thereof the following new section:

"SEC. 6050H. RETURNS RELATING TO RECEIPT OF MORTGAGE INTEREST IN TRADE OR BUSINESS.

"(a) MORTGAGE INTEREST OF $600 OR MORE.—Any person—

"(1) who is engaged in a trade or business, and

"(2) who, in the course of such trade or business, receives from any other person interest—

"(A) on 1 or more obligations which are secured by the same real property, and

"(B) aggregating $600 or more for any calendar year, shall make the return described in subsection (b) with respect to each person from whom such interest was received at such time as the Secretary may by regulations prescribe.

"(b) FORM AND MANNER OF RETURNS.—A return is described in this subsection if such return—

"(1) is in such form as the Secretary may prescribe,

"(2) contains—

"(A) the name and address of the person from whom the interest was received,

"(B) the amount of interest received for the calendar year, and

"(C) such other information as the Secretary may prescribe.

"(c) APPLICATION TO GOVERNMENTAL UNITS.—For purposes of subsection (a)—

"(1) TREATED AS PERSONS.—The term 'person' includes any governmental unit (and any agency or instrumentality thereof).

"(2) SPECIAL RULES.—In the case of a governmental entity or any agency or instrumentality thereof—

"(A) subsection (a) shall be applied without regard to the trade or business requirement contained therein, and

"(B) any return required under subsection (a) shall be made by the officer or employee appropriately designated for the purpose of making such return.

"(d) STATEMENTS TO BE FURNISHED TO PERSONS WITH RESPECT TO WHOM INFORMATION IS FURNISHED.—Every person making a return under subsection (a) shall furnish to each person whose name is set forth in such return a written statement showing—

"(1) the name and address of the person making such return, and

"(2) the aggregate amount of interest received by the person making such return.

The written statement required under the preceding sentence shall be furnished on or before January 31 of the year following the calendar year for which the return under subsection (a) was made."

(b) PENALTIES.—

(1) Subparagraph (B) of section 6652(a)(1) (relating to failure to file certain information returns, etc.) is amended—

(A) by striking out "or" at the end of clause (iii),

(B) by inserting "or" at the end of clause (iv), and

(C) by inserting after clause (iv) the following new clause:

"(v) section 6050H(a) (relating to mortgage interest received in trade or business),".

(2) Clause (iii) of section 6652(a)(3)(A) (relating to penalty in case of intentional disregard) is amended by inserting "or section 6050H" after "section 6041A(b)".

(3) Paragraph (1) of section 6678(a) (relating to failure to furnish certain statements) is amended—

(A) by striking out "or 6052(b)" and inserting in lieu thereof "6052(b), or 6050H(d)", and

(B) by striking out "or 6052(a)" and inserting in lieu thereof "6052(a), or 6050H(a)".

(c) Conforming Amendment.—The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new item:

"Sec. 6050H. Returns relating to mortgage interest received in trade or business."

(d) Effective Date.—The amendments made by this section shall apply to amounts received after December 31, 1984.

SEC. 153. RETURNS RELATING TO FORECLOSURES AND ABANDONMENTS OF SECURITY.

(a) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by adding at the end thereof the following new section:

"SEC. 6050I. RETURNS RELATING TO FORECLOSURES AND ABANDONMENTS OF SECURITY.

"(a) IN GENERAL.—Any person who, in connection with a trade or business conducted by such person, lends money secured by property and who—

"(1) in full or partial satisfaction of any indebtedness, acquires an interest in any property which is security for such indebtedness, or

"(2) has reason to know that the property in which such person has a security interest has been abandoned,

shall make a return described in subsection (c) with respect to each of such acquisitions or abandonments, at such time as the Secretary may by regulations prescribe.

"(b) EXCEPTIONS.—

"(1) INDEBTEDNESS LESS THAN $15,000.—Subsection (a) shall not apply if the indebtedness is less than $15,000. For purposes of the preceding sentence, all indebtedness arising out of any transaction (or series of related transactions) shall be aggregated.

"(2) CONSUMER LOANS.—Subsection (a) shall not apply to any loan to an individual secured by an interest in tangible personal property which is not held for investment and which is not used in a trade or business.

"(c) FORM AND MANNER OF RETURN.—The return required under subsection (a) with respect to any acquisition or abandonment of property—

"(1) shall be in such form as the Secretary may prescribe,

"(2) shall contain—

"(A) the name and address of each person who is a borrower with respect to the indebtedness which is secured,

"(B) a general description of the nature of such property and such indebtedness,

"(C) in the case of a return required under subsection (a)(1)—

"(i) the amount of such indebtedness at the time of such acquisition, and

"(ii) the amount of indebtedness satisfied in such acquisition,

"(D) in the case of a return required under subsection (a)(2), the amount of such indebtedness at the time of such abandonment, and

"(E) such other information as the Secretary may prescribe.

"(d) APPLICATIONS TO GOVERNMENTAL UNITS.—For purposes of this section—

"(1) TREATED AS PERSONS.—The term 'person' includes any governmental unit (and any agency or instrumentality thereof).

"(2) SPECIAL RULES.—In the case of a governmental entity or any agency or instrumentality thereof—

"(A) subsection (a) shall be applied without regard to the trade or business requirement contained therein, and

"(B) any return under this section shall be made by the officer or employee appropriately designated for the purpose of making such return.

"(e) STATEMENTS TO BE FURNISHED TO PERSONS WITH RESPECT TO WHOM INFORMATION IS REQUIRED TO BE FURNISHED.—Every person required to make a return under subsection (a) shall furnish to each person whose name is required to be set forth in such return a written statement showing the name and address of the person required to make such return. The written statement required under the preceding sentence shall be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a) was made.

"(f) TREATMENT OF OTHER DISPOSITIONS.—To the extent provided by regulations prescribed by the Secretary, any transfer of the property which secures the indebtedness to a person other than the lender shall be treated as an abandonment of such property."

(b) PENALTIES.—

(1) Subparagraph (B) of section 6652(a)(1) (relating to failure to file certain information returns, etc.) is amended—

(A) by striking out "or" at the end of clause (iv),

(B) by adding "or" at the end of clause (v), and

(C) by inserting after clause (v) the following new clause:

"(vi) section 6050I (relating to foreclosures and abandonments of security),".

(2) Clause (iii) of section 6652(a)(3)(A) (relating to penalty in case of intentional disregard) is amended by striking out "or section 6050H" and inserting in lieu thereof ", section 6050H, or section 6050I".

(3) Paragraph (1) of section 6678(a) (relating to failure to furnish certain statements) is amended—

(A) by striking out "or 6050H(d)" and inserting in lieu thereof "6050H(d), or 6050I(e)", and

(B) by striking out "or 6050H(a)" and inserting in lieu thereof "6050H(a), or 6050I(a)".

(c) CONFORMING AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new item:

"Sec. 6050I. Returns relating to foreclosures and abandonments of security."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to acquisitions of property and abandonments of property after December 31, 1984.

SEC. 154. INCREASE IN PENALTY FOR PROMOTING ABUSIVE TAX SHELTERS.

(a) IN GENERAL.—Subsection (a) of section 6700 (relating to promotion of abusive tax shelters) is amended by striking out "10 percent" and inserting in lieu thereof "20 percent".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on the date of the enactment of this Act.

SEC. 155. REPORTING OF STATE AND LOCAL REFUNDS NOT REQUIRED WITH RESPECT TO NON-ITEMIZERS.

(a) IN GENERAL.—Subsection (a) of section 6050E (relating to State and local income tax refunds) is amended by adding at the end thereof the following: "No return shall be required under the preceding sentence with respect to any individual if it is determined (in the manner provided by regulations) that such individual did not claim itemized deductions under chapter 1 for the taxable year giving rise to the refund, credit, or offset."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to payments of refunds, and credits and offsets made, after December 31, 1982.

SEC. 156. AUTHORIZATION TO DISREGARD APPRAISALS OF PERSONS PENALIZED FOR AIDING IN UNDERSTATEMENTS OF TAX LIABILITY.

(a) IN GENERAL.—Section 330 of title 31, United States Code, is amended by adding at the end thereof the following new subsection:

"(c) After notice and opportunity for a hearing to any appraiser with respect to whom a penalty has been assessed under section 6701(a) of the Internal Revenue Code of 1954, the Secretary may—

"(1) provide that appraisals by such appraiser shall not have any probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service, and

"(2) bar such appraiser from presenting evidence or testimony in any such proceeding."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to penalties assessed after the date of the enactment of this Act.

SEC. 157. PROVISIONS RELATING TO INDIVIDUAL RETIREMENT ACCOUNTS.

(a) CLARIFICATION THAT REGULATIONS MAY REQUIRE REPORTS TO IDENTIFY YEARS TO WHICH CONTRIBUTIONS RELATE.—Subsection (i) of section 408 (relating to individual retirement accounts) is amended by inserting "(and the years to which they relate)" after "contributions".

(b) INCREASE IN PENALTY FOR FAILURE TO FILE REPORTS.—Subsection (a) of section 6693 (relating to failure to provide reports on individual retirement accounts and annuities) is amended by striking out "$10" and inserting in lieu thereof "$50".

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to contributions made after April 15, 1984, for taxable years beginning after December 31, 1983.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to failures occurring after the date of the enactment of this Act.

SEC. 158. RETURNS RELATING TO EXCHANGES OF PARTNERSHIP INTERESTS WHERE UNREALIZED RECEIVABLES, ETC., INVOLVED.

(a) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 (relating to information and returns) is amended by adding at the end thereof the following new section:

"SEC. 6050J. RETURNS RELATING TO EXCHANGES OF CERTAIN PARTNERSHIP INTERESTS.

"(a) IN GENERAL.—Except as provided in regulations prescribed by the Secretary, if there is an exchange described in section 751(a) of any interest in a partnership during any calendar year, such partnership shall make a return for such calendar year stating—

"(1) the name and address of the transferee and transferor in such exchange, and

"(2) such other information as the Secretary may by regulations prescribe.

Such return shall be made at such time and in such manner as the Secretary may require by regulations.

"(b) STATEMENT TO BE FURNISHED TO TRANSFEROR AND TRANSFEREE.—Every partnership making a return under subsection (a) shall furnish to each person whose name is set forth in such return a written statement showing—

"(1) the name and address of the partnership making the return, and

"(2) the information shown on the return with respect to such person.

The statement required under the preceding sentence shall be furnished to the person on or before January 31 following the calendar year for which the return under subsection (a) was made."

(b) PENALTIES.—

(1) Subparagraph (B) of section 6652(a)(1) (relating to failure to file certain information returns, etc.) is amended by striking out "or" at the end of clause (v), by adding "or" at the end of clause (vi), and by inserting after clause (vi) the following new clause:

"(vii) section 6050J (relating to exchanges of certain partnership interests),".

(2) Paragraph (1) of section 6678(a) (relating to failure to furnish certain statements) is amended—

(A) by striking out "or 6050I(e)" and inserting in lieu thereof "6050I(e), or 6050J(b)", and

(B) by striking out "or 6050I(a)" and inserting in lieu thereof "6050I(a), or 6050J(a)".

(c) CONFORMING AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by adding at the end thereof the following new item:

"Sec. 6050J. Returns relating to exchanges of certain partnership interests."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to exchanges after December 31, 1984.

SEC. 159. STATEMENTS REQUIRED IN CASE OF CERTAIN SUBSTITUTE DIVIDEND PAYMENTS.

(a) GENERAL RULE.—Section 6045 (relating to returns of brokers) is amended by adding at the end thereof the following new subsection:

"(d) STATEMENTS REQUIRED IN CASE OF CERTAIN SUBSTITUTE DIVIDEND PAYMENTS.—If—

"(1) any broker in stocks or securities lends stock of a corporate customer for use in a short sale, and

"(2) receives (on behalf of the customer) a payment in lieu of a dividend on such stock during the period such short sale is open,

such broker shall furnish such customer a written statement (at the time and in the manner prescribed by regulations) identifying such payment as being in lieu of a dividend payment."

(b) Effective Date.—The amendment made by subsection (a) shall apply to payments received after December 31, 1984.

Subtitle L—Miscellaneous Provisions

SEC. 161. INCLUSION OF TAX BENEFIT ITEMS IN INCOME.

(a) In General.—Section 111 (relating to recovery of bad debts, prior taxes, and delinquency amounts) is amended to read as follows:

"SEC. 111. RECOVERY OF TAX BENEFIT ITEMS.

"(a) Deductions.—Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce income subject to tax.

"(b) Credits.—

"(1) In general.—If—

"(A) a credit was allowable with respect to any amount for any prior taxable year, and

"(B) such amount is recovered during the taxable year,

the tax imposed by this chapter for the taxable year shall be increased by the amount of the credit attributable to the recovered amount.

"(2) Exception where credit did not reduce tax.—Paragraph (1) shall not apply to the extent that the credit allowable for the recovered amount did not reduce the amount of tax imposed by this chapter.

"(3) EXCEPTION FOR INVESTMENT TAX CREDIT AND FOREIGN TAX CREDIT.—This subsection shall not apply with respect to the investment tax credit and the foreign tax credit.

"(c) TREATMENT OF CARRYOVERS.—For purposes of this section, an increase in a carryover which has not expired before the beginning of the taxable year in which the recovery takes place shall be treated as reducing income subject to tax or reducing tax imposed by this chapter, as the case may be.

"(d) SPECIAL RULES FOR ACCUMULATED EARNINGS TAX AND FOR PERSONAL HOLDING COMPANY TAX.—In applying subsection (a) for the purpose of determining the accumulated earnings tax under section 531 or the tax under section 541 (relating to personal holding companies)—

"(1) any excluded amount under subsection (a) allowed for the purposes of this subtitle (other than section 531 or section 541) shall be allowed whether or not such amount resulted in a reduction of the tax under section 531 or the tax under section 541 for the prior taxable year; and

"(2) where any excluded amount under subsection (a) was not allowable as a deduction for the prior taxable year for purposes of this subtitle other than of section 531 or section 541 but was allowable for the same taxable year under section 531 or section 541, then such excluded amount shall be allowable if it did not result in a reduction of the tax under section 531 or the tax under section 541."

(b) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by striking out the item relating to section 111 and inserting in lieu thereof:

"Sec. 111. Recovery of tax benefit items."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to amounts recovered after December 31, 1983, in taxable years ending after such date.

SEC. 162. LOANS WITH BELOW-MARKET INTEREST RATES.

(a) GENERAL RULE.—Subchapter C of chapter 80 (relating to provisions affecting more than 1 subtitle) is amended by adding at the end thereof the following new section:

"SEC. 7872. TREATMENT OF LOANS WITH BELOW-MARKET INTEREST RATES.

"(a) TREATMENT OF FAMILY LOANS AND DEMAND LOANS.—

"(1) IN GENERAL.—For purposes of this title, in the case of any below-market loan which is a family loan or a demand loan, the foregone interest shall be treated as—

"(A) transferred from the lender to the borrower, and

"(B) retransferred by the borrower to the lender as interest.

"(2) TIME WHEN TRANSFERS MADE.—Except as otherwise provided in regulations prescribed by the Secretary, any foregone interest attributable to periods during any calendar year shall be treated as transferred (and retransferred) under paragraph (1) on the last day of such calendar year.

"(b) TREATMENT OF OTHER BELOW-MARKET LOANS.—

"(1) IN GENERAL.—For purposes of this title, in the case of any below-market loan to which subsection (a)(1) does not apply, the excess of—

"(A) the amount loaned, over

"(B) the present value of all payments due under such loan,

shall be treated as property transferred by the lender to the borrower on the date the loan was made.

"(2) TREATMENT OF EXCESS.—For purposes of this title, any excess described in paragraph (1) shall be—

"(A) deductible to the borrower as interest, and

"(B) included in the gross income of the lender as interest,

under principles similar to the principles of section 1272(a).

"(c) BELOW-MARKET LOAN.—For purposes of this section, the term 'below-market loan' means any loan if—

"(1) in the case of a demand loan, interest is payable on the loan at a rate less than the applicable Federal rate, or

"(2) in the case of a term loan, the amount loaned exceeds the present value of all payments due under the loan.

"(d) FOREGONE INTEREST.—For purposes of this section, the term 'foregone interest' means, with respect to any period during which the loan is outstanding, the excess of—

"(1) the amount of interest which would have accrued on the loan during the period if interest accrued on the loan at the applicable Federal rate, over

"(2) any interest payable on the loan properly allocable to such period.

"(e) SPECIAL RULES FOR FAMILY LOANS.—In the case of a family loan—

"(1) the amount treated as retransferred by the borrower to the lender shall not exceed any income realized by the borrower which is attributable to the loan; and

"(2) subsection (b) shall apply for purposes of chapter 12.

"(f) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) PRESENT VALUE.—The present value of any payment shall be determined in the manner provided by regulations prescribed by the Secretary—

"(A) as of the date of the loan, and

"(B) by using a discount rate equal to the applicable Federal rate.

"(2) APPLICABLE FEDERAL RATE.—In the case of any loan, the applicable Federal rate shall be the applicable Federal rate in effect under section 1274(d) (as of the day on which the loan was made), compounded semiannually.

"(3) FAMILY LOAN.—The term 'family loan' means any below-market loan where the foregone interest is a gift (within the meaning of section 2501).

"(4) AMOUNT LOANED.—The term 'amount loaned' means the amount received by the borrower.

"(g) EXCEPTIONS.—

"(1) WHERE TAX AVOIDANCE NOT A PRINCIPAL PURPOSE.—Under regulations prescribed by the Secretary, this section shall not apply if it is established to the satisfaction of the Secretary that the loan did not have as 1 of its principal purposes the avoidance of any Federal tax.

"(2) LOANS TO WHICH SECTION 483 OR 1274 APPLIES.—This section shall not apply to any loan to which section 483 or 1274 applies.

"(h) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations providing that where, by reason of varying rates of interest, conditional interest payments, waivers of interest, or other circumstances, the provisions of this section do not carry out the purposes of this section, adjustments to the provisions of this section will be made to the extent necessary to carry out the purposes of this section."

(b) CLERICAL AMENDMENT.—The table of sections for subchapter C of chapter 80 is amended by adding at the end thereof the following new item:

"Sec. 7872. Treatment of loans with below-market interest rates."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to—

(A) term loans made after March 1, 1984, and

(B) demand loans outstanding after March 1, 1984.

(2) Exception for demand loans outstanding on March 1, 1984, and repaid within 60 days after date of enactment.—The amendments made by this section shall not apply to any demand loan which—

(A) was outstanding on March 1, 1984, and

(B) was repaid before the date 60 days after the date of the enactment of this Act.

(3) Treatment of renegotiations, etc.—For purposes of this subsection, any loan renegotiated, extended, or revised after March 1, 1984, shall be treated as a loan made after such date.

SEC. 163. LIFO CONFORMITY RULES APPLIED ON CONTROLLED GROUP BASIS.

(a) General Rule.—Section 472 (relating to last-in, first-out inventories) is amended by adding at the end thereof the following new subsection:

"(g) Conformity Rules Applied on Controlled Group Basis.—

"(1) In general.—Except as otherwise provided in regulations, all members of the same group of financially related corporations shall be treated as 1 taxpayer for purposes of subsections (c) and (e)(2).

"(2) GROUP OF FINANCIALLY RELATED CORPORATIONS.—For purposes of paragraph (1), the term 'group of financially related corporations' means—

"(A) any affiliated group as defined in section 1504 determined by substituting '50 percent' for '80 percent' each place it appears in section 1504(a) and without regard to section 1504(b), and

"(B) any other group of corporations which consolidate for purposes of financial statements."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 164. TREATMENT OF COLLAPSIBLE CORPORATIONS.

(a) AMOUNT OF GAIN REQUIRED TO BE RECOGNIZED.—Subparagraph (A) of section 341(b)(1) (defining collapsible corporation) is amended by striking out "a substantial party" and inserting in lieu thereof "⅔".

(b) AGGREGATION FOR PURPOSES OF SECTION 341(d)(2).—Subsection (d) of section 341 (relating to limitations on application of section) is amended by adding at the end thereof the following sentence: "In determining whether property is described in subsection (b)(1) for purposes of applying paragraph (2), all property described in section 1221(1) shall, to the extent provided in regulations prescribed by the Secretary, be treated as one item of property."

(c) CONFORMING AMENDMENT.—Paragraph (2) of section 341(d) is amended by striking out "so manufactured, constructed, produced, or purchased" and inserting in lieu thereof "described in subsection (b)(1)".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to sales, exchanges, and distributions after the date of the enactment of this Act in taxable years ending after such date.

SEC. 165. ELIGIBILITY FOR INCOME AVERAGING.

(a) BASE PERIOD SHORTENED TO 3 YEARS.—Paragraph (2) of section 1302(c) (relating to definition of averagable income; related definitions) is amended by striking out "4 taxable years" and inserting in lieu thereof "3 taxable years".

(b) INCREASE IN PERCENTAGE OF AVERAGE BASE INCOME TAKEN INTO ACCOUNT.—Section 1301 (relating to limitation on tax) is amended by striking out "120 percent" and inserting in lieu thereof "140 percent".

(c) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Section 1301 (relating to limitation on tax) is amended—

(A) by striking out "5 times" and inserting in lieu thereof "4 times", and

(B) by striking out "20 percent" and inserting in lieu thereof "25 percent".

(2) Paragraph (1) of section 1302(a) (defining averagable income) is amended by striking out "120 percent" and inserting in lieu thereof "140 percent".

(3) Paragraph (1) of section 1302(b) (defining average base period income) is amended by striking out "one-fourth" and inserting in lieu thereof "⅓".

(4) Paragraph (3) of section 1302(c) is amended by striking out "4 taxable years" and inserting in lieu thereof "3 taxable years".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to computation years beginning after December 31, 1983, and to base period years applicable to such computation years.

SEC. 166. LIMITATION ON AMOUNT OF DEPRECIATION AND INVESTMENT TAX CREDIT ALLOWABLE FOR LUXURY AUTOMOBILES.

(a) GENERAL RULE.—Subsection (d) of section 168 (relating to unadjusted basis; adjustments) is amended by adding at the end thereof the following new paragraph:

"(3) LIMITATION IN CASE OF LUXURY AUTOMOBILES.—

"(A) In general.—In the case of a passenger automobile, the aggregate basis of such automobile taken into account by all persons holding interests in the automobile—

"(i) for purposes of determining the amount of the deduction allowable under this section (and any other deduction allowable for depreciation or amortization),

"(ii) for purposes of determining the amount of the credit allowable under section 38, and

"(iii) for purposes of section 179,

shall not exceed $21,000 increased by the automobile price inflation adjustment (if any) for the calendar year in which the automobile is placed in service.

"(B) Passenger automobile.—For purposes of this paragraph—

"(i) In general.—Except as provided in clause (ii), the term 'passenger automobile' means any 4-wheeled vehicle—

"(I) which is manufactured primarily for use on public streets, roads, and highways, and

"(II) which is rated at 6,000 pounds gross vehicle weight or less.

"(ii) EXCEPTION FOR CERTAIN VEHICLES.—The term 'passenger automobile' shall not include—

"(I) any ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in a trade or business,

"(II) any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire, and

"(III) under regulations, any truck or van.

"(C) AUTOMOBILE PRICE INFLATION ADJUSTMENT.—For purposes of this paragraph—

"(i) IN GENERAL.—The automobile price inflation adjustment for any calendar year is the percentage (if any) by which—

"(I) the CPI automobile component for November of the preceding calendar year, exceeds

"(II) the CPI automobile component for November of 1983.

In the case of calendar year 1984, the automobile price inflation adjustment shall be zero.

"(ii) CPI AUTOMOBILE COMPONENT.—The term 'CPI automobile component' means the automobile component of the Consumer Price Index for All Urban Consumers published by the Department of Labor.

"(D) COORDINATION WITH SECTION 1031.—In the case of an exchange described in section 1031 where the property received in the exchange is a passenger automobile, the excess of the fair market value of such property over the limitation of subparagraph (A) shall be treated as an amount received in cash for purposes of section 1031.

"(E) TREATMENT OF LEASES.—

"(i) EXCEPTION FOR LESSORS.—This paragraph shall not apply to any passenger automobile leased or held for leasing by any person regularly engaged in the business of leasing passenger automobiles.

"(ii) TREATMENT OF LESSEES.—For purposes of determining the amount allowable as a deduction under this chapter for rentals or other payments under a lease for a period of 30 days or more of a passenger automobile, only the allowable portion of such payments shall be taken into account.

"(iii) ALLOWABLE PORTION.—The term 'allowable portion' means, with respect to any lease of an automobile, the fraction—

"(I) the numerator of which is the limitation of subparagraph (A) in effect for the calendar year in which the automobile is placed in service under the lease, and

"(II) the denominator of which is the fair market value of such automobile when so placed in service."

(b) PRESUMPTION THAT AT LEAST 50 PERCENT OF USE OF AUTOMOBILE IS FOR PERSONAL PURPOSES.—Section 162 (relating to trade or business expenses) is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

"(j) PRESUMPTION THAT AT LEAST 50 PERCENT OF USE OF AUTOMOBILE IS FOR PERSONAL PURPOSES.—

"(1) IN GENERAL.—For purposes of this title, at least 50 percent of the use of any passenger automobile during any taxable year shall be treated as personal use unless the taxpayer establishes otherwise by adequate records or by sufficient evidence corroborating his own statement.

"(2) DEFINITIONS.—For purposes of this section—

"(A) PASSENGER AUTOMOBILE.—The term 'passenger automobile' has the meaning given such term by section 168(d)(3)(B).

"(B) PERSONAL USE.—The term 'personal use' means any use which is not in a trade or business and is not in any activity described in section 212."

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall apply to property placed in service after March 1, 1984, in taxable years ending after such date.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to taxable years beginning after December 31, 1984.

SEC. 167. AMENDMENTS TO SECTION 1239.

(a) PATENT APPLICATIONS TREATED AS DEPRECIABLE PROPERTY.—Section 1239 (relating to gain from sale of depreciable property between certain related taxpayers) is amended by adding at the end thereof the following new subsection:

"(e) PATENT APPLICATIONS TREATED AS DEPRECIABLE PROPERTY.—For purposes of this section, a patent application shall be treated as property which, in the hands of the transferee, is of a character which is subject to the allowance for depreciation provided in section 167."

(b) TAXPAYER AND CERTAIN TRUSTS TREATED AS RELATED PERSONS.—Subsection (b) of section 1239 is amended to read as follows:

"(b) RELATED PERSONS.—For purposes of subsection (a), the term 'related person' means—

"(1) a husband and wife,

"(2) a person and all entities which are 80-percent owned entities with respect to such person,

"(3) a taxpayer and any trust in which such taxpayer (or his spouse) is a beneficiary, unless such beneficiary's interest in the trust is a remote contingent interest (within the meaning of section 318(a)(3)(B)(i))."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales or exchanges after March 1, 1984, in taxable years ending after such date.

SEC. 168. AMENDMENTS TO SECTION 267.

(a) ALLOWANCE OF DEDUCTION WHERE EXPENSES AND INTEREST ARE PAID TO RELATED CASH-BASIS TAXPAYERS AFTER 2½-MONTH PERIOD.—

(1) IN GENERAL.—Subsection (a) of section 267 (relating to losses, expenses, and interest with respect to transactions between related taxpayers) is amended to read as follows:

"(a) IN GENERAL.—

"(1) DEDUCTION FOR LOSSES DISALLOWED.—No deduction shall be allowed in respect of any loss from the sale or exchange of property (other than a loss in case of a distribution in corporate liquidation), directly or indirectly, between persons specified in any of the paragraphs of subsection (b).

"(2) MATCHING OF DEDUCTION AND PAYEE INCOME ITEM IN THE CASE OF EXPENSES AND INTEREST.—If—

"(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

"(B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are persons specified in any of the paragraphs of subsection (b),

then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph)."

(2) CONFORMING AMENDMENT.—Subsection (e) of section 267 (relating to rule where last day of 2½-month period falls on Sunday, etc.) is hereby repealed.

(b) EXTENSION OF SECTION 267 TO CERTAIN RELATED ENTRIES.—

(1) PASS-THRU ENTITIES.—Section 267 is amended by striking out subsection (f) and inserting in lieu thereof the following:

"(e) SPECIAL RULES FOR PASS-THRU ENTITIES.—

"(1) IN GENERAL.—In the case of any amount paid or incurred by, to, or on behalf of, a pass-thru entity, for purposes of applying subsection (a)(2)—

"(A) such entity,

"(B) in the case of—

"(i) a partnership, any person who owns (directly or indirectly) any capital interest or profits interest of such partnership, or "(ii) an S corporation, any person who owns (directly or indirectly) any of the stock of such corporation,

"(C) any person who owns (directly or indirectly) any capital interest or profits interest of a partnership in which such entity owns (directly or indirectly) any capital interest or profits interest, and

"(D) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to a person described in subparagraph (B) or (C),

shall be treated as persons specified in a paragraph of subsection (b). Subparagraph (C) shall apply to a transaction only if such transaction is related either to the operations the partnership described in such subparagraph or to an interest in such partnership.

"(2) PASS-THRU ENTITY.—For purposes of this section, the term 'pass-thru entity' means—

"(A) a partnership, and

"(B) an S corporation.

"(3) CONSTRUCTIVE OWNERSHIP IN THE CASE OF PARTNERSHIPS.—For purposes of determining ownership of a capital interest or profits interest of a partnership, the principles of subsection (c) (other than paragraph (3)) shall apply.

"(4) SUBSECTION (a)(2) NOT TO APPLY TO CERTAIN GUARANTEED PAYMENTS OF PARTNERSHIPS.—In the case of any amount paid or incurred by a partnership, subsection (a)(2) shall not apply to the extent that section 707(c) applies to such amount."

(2) CERTAIN CONTROLLED GROUPS.—

(A) Paragraph (3) of section 267(b) is amended to read as follows:

"(3) Two corporations which are members of the same controlled group (as defined in subsection (f));".

(B) Section 267 is amended by adding at the end thereof the following new subsection:

"(f) CONTROLLED GROUP DEFINED.

"(1) IN GENERAL.—For purposes of subsection (b)(3), the term 'controlled group' has the meaning given to such term by section 1563(a), except that—

"(A) 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears in section 1563(a), and

"(B) the determination shall be made without regard to subsections (a)(4) and (e)(3(C) of section 1563.

"(2) LOSS DISALLOWANCE RULE NOT TO APPLY TO A TRANSFER TO A DISC.—For purposes of applying subsection (a)(1), the term 'controlled group' shall not include a DISC."

(3) CORPORATION AND PARTNERSHIP OWNED BY SAME PERSONS.—Paragraph (10) of section 267(b) is amended—

(A) by striking out "An S corporation" and inserting in lieu thereof "A corporation", and

(B) by striking out "the S corporation" and inserting in lieu thereof "the corporation".

(4) S CORPORATION AND C CORPORATION OWNED BY SAME PERSONS.—Paragraph (12) of section 267(b) is amended by striking out "the same individual" and inserting in lieu thereof "the same persons".

(5) TECHNICAL AMENDMENTS.—

(A) Paragraph (3) of section 170(a) is amended by striking out "section 267(b)" and inserting in lieu thereof "section 267(b) or 707(b)".

(B) Clause (iii) of section 514(c)(9)(B) is amended by striking out "section 267(b)" and inserting in lieu thereof "section 267(b) or 707(b)".

(C) Subsection (d) of section 1235 is amended—

(i) by striking out "section 267(b)" in the matter preceding paragraph (1) and inserting in lieu thereof "section 267(b) or persons described in section 707(b)",

(ii) by striking out "section 267 (b) and (c)" and inserting in lieu thereof "section 267 (b) and (c) and section 707(b)", and

(iii) by striking out "section 267(b)" in paragraph (1) and inserting in lieu thereof "section 267(b) or 707(b)".

(D) Subparagraph (F) of section 368(a)(2) is amended by striking out clause (viii).

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendments made by subsection (a) shall apply to amounts allowable as deductions under chapter 1 of the Internal Revenue Code of 1954 for taxable years beginning after December 31, 1983. For purposes of the preceding sentence, the allowability of a deduction shall be determined without regard to any disallowance or the postponement of deductions under section 267 of such Code.

(2) SUBSECTION (b).—

(A) IN GENERAL.—Except as provided in subparagraph (B), the amendments made by subsection (b) shall apply to transactions after September 29, 1983, in taxable years ending after such date.

(B) EXCEPTION FOR TRANSFERS TO FOREIGN CORPORATIONS ON OR BEFORE MARCH 1, 1984.—The amendments made by subsection (b)(2) shall not apply to property transferred to a foreign corporation on or before March 1, 1984.

(3) EXCEPTION FOR EXISTING INDEBTEDNESS, ETC.—

(A) IN GENERAL.—The amendments made by this section shall not apply to any amount paid or incurred—

(i) on indebtedness incurred on or before September 29, 1983, or

(ii) pursuant to a contract which was binding on September 29, 1983, and at all times thereafter before the amount is paid or incurred.

(B) TREATMENT OF RENEGOTIATIONS, EXTENSIONS, ETC.—If any indebtedness (or contract described in subparagraph (A)) is renegotiated, extended, renewed, or revised after September 29, 1983, subparagraph (A) shall not apply to any amount paid or incurred on such indebtedness (or pursuant to such contract) after the date of such renegotiation, extension, renewal, or revision.

TITLE II—LIFE INSURANCE PROVISIONS

SEC. 201. SHORT TITLE; ETC.

(a) SHORT TITLE.—This title may be cited as the "Life Insurance Tax Act of 1984".

(b) TABLE OF CONTENTS.—

TITLE II—LIFE INSURANCE PROVISIONS

Sec. 201. Short title; etc.

Subtitle A—Taxation of Life Insurance Companies

PART I—AMENDMENT OF SUBCHAPTER L

Sec. 211. Amendment of subchapter L.

PART II—EFFECTIVE DATE; TRANSITIONAL RULES

SUBPART A—EFFECTIVE DATE

Sec. 215. Effective date.

SUBPART B—TRANSITIONAL RULES

Sec. 216. Reserves computed on new basis; fresh start.
Sec. 217. Other special rules.

Subtitle B—Taxation of Life Insurance Products

Sec. 221. Definition of life insurance contract.
Sec. 222. Treatment of certain annuity contracts.
Sec. 223. Limitation on interest deduction in case of life insurance loans.
Sec. 224. Group-term life insurance purchased for employees.

Subtitle C—Nondeductible Contributions to Individual Retirement Plans

Sec. 231. Nondeductible contributions permitted to individual retirement plans.

Subtitle D—Studies

Sec. 241. Studies.

(c) TABLE OF SECTIONS FOR PART I OF SUBCHAPTER L.—Under the amendment to part I of subchapter L made by section 211(a), the subparts and sections of such part I will be as follows:

PART I—LIFE INSURANCE COMPANIES

SUBPART A—TAX IMPOSED

Sec. 801. Tax imposed.

SUBPART B—LIFE INSURANCE GROSS INCOME

Sec. 803. Life insurance gross income.

SUBPART C—LIFE INSURANCE DEDUCTIONS

Sec. 804. Life insurance deductions.
Sec. 805. General deductions.
Sec. 806. Special deductions.
Sec. 807. Rules for certain reserves.
Sec. 808. Policyholder dividends deduction.
Sec. 809. Reduction in certain deductions of mutual life insurance companies.
Sec. 810. Operations loss deduction.

SUBPART D—ACCOUNTING, ALLOCATION, AND FOREIGN PROVISIONS

Sec. 811. Accounting provisions.
Sec. 812. Definition of company's share and policyholders' share.
Sec. 813. Foreign life insurance companies.
Sec. 814. Contiguous country branches of domestic life insurance companies.
Sec. 815. Distributions to shareholders from pre-1984 policyholders surplus account.

SUBPART E—DEFINITIONS AND SPECIAL RULES

Sec. 816. Life insurance company defined.
Sec. 817. Treatment of variable contracts.
Sec. 818. Other definitions and special rules.

Subtitle A—Taxation of Life Insurance Companies

PART I—AMENDMENT OF SUBCHAPTER L

SEC. 211. AMENDMENT OF SUBCHAPTER L.

(a) GENERAL RULE.—Part I of subchapter L of chapter 1 is amended to read as follows:

"PART I—LIFE INSURANCE COMPANIES

"Subpart A. Tax imposed.

"Subpart B. Life insurance gross income.
"Subpart C. Life insurance deductions.
"Subpart D. Accounting, allocation, and foreign provisions.
"Subpart E. Definitions and special rules.

"Subpart A—Tax Imposed

"Sec. 801. Tax imposed.

"SEC. 801. TAX IMPOSED.

"(a) Tax Imposed.—

"(1) In general.—A tax is hereby imposed for each taxable year on the life insurance company taxable income of every life insurance company. Such tax shall consist of a tax computed as provided in section 11 as though the life insurance company taxable income were the taxable income referred to in section 11.

"(2) Alternative tax in case of capital gains.—

"(A) In general.—If a life insurance company has a net capital gain for the taxable year, then (in lieu of the tax imposed by paragraph (1)), there is hereby imposed a tax (if such tax is less than the tax imposed by paragraph (1)).

"(B) Amount of tax.—The amount of the tax imposed by this paragraph shall be the sum of—

"(i) a partial tax, computed as provided by paragraph (1), on the life insurance company taxable income reduced by the amount of the net capital gain, and

"(ii) an amount determined as provided in section 1201(a) on such net capital gain.

"(C) NET CAPITAL GAIN NOT TAKEN INTO ACCOUNT IN DETERMINING SPECIAL LIFE INSURANCE COMPANY DEDUCTION AND SMALL LIFE INSURANCE COMPANY DEDUCTION.—For purposes of subparagraph (B)(i), the amounts allowable as deductions under paragraphs (2) and (3) of section 804 shall be determined by reducing the tentative LICTI by the amount of the net capital gain (determined without regard to items attributable to noninsurance businesses).

"(b) LIFE INSURANCE COMPANY TAXABLE INCOME.—For purposes of this part, the term 'life insurance company taxable income' means—

"(1) life insurance gross income, reduced by

"(2) life insurance deductions.

"(c) LIFE INSURANCE COMPANY TAXABLE INCOME INCREASED BY DISTRIBUTIONS FROM PRE-1984 POLICYHOLDERS SURPLUS ACCOUNT.—

"For provision increasing life insurance company taxable income for distributions to shareholders from pre-1984 policyholders surplus account, see section 815.

"Subpart B—Life Insurance Gross Income

"Sec. 803. Life insurance gross income.

"SEC. 803. LIFE INSURANCE GROSS INCOME.

"(a) IN GENERAL.—For purposes of this part, the term 'life insurance gross income' means the sum of the following amounts:

"(1) PREMIUMS.—

"(A) The gross amount of premiums and other consideration on insurance and annuity contracts, less

"(B) return premiums, and premiums and other consideration arising out of indemnity reinsurance.

"(2) DECREASES IN CERTAIN RESERVES.—Each net decrease in reserves which is required by section 807(a) to be taken into account under this paragraph.

"(3) OTHER AMOUNTS.—All amounts not includible under paragraph (1) or (2) which under this subtitle are includible in gross income.

"(b) SPECIAL RULES FOR PREMIUMS.—

"(1) CERTAIN ITEMS INCLUDED.—For purposes of subsection (a)(1)(A), the term 'gross amount of premiums and other consideration' includes—

"(A) advance premiums,

"(B) deposits,

"(C) fees,

"(D) assessments,

"(E) consideration in respect of assuming liabilities under contracts not issued by the taxpayer, and

"(F) the amount of policyholder dividends reimbursable to the taxpayer by a reinsurer in respect of reinsured policies,

on insurance and annuity contracts.

"(2) POLICYHOLDER DIVIDENDS EXCLUDED FROM RETURN PREMIUMS.—For purposes of subsection (a)(1)(B)—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'return premiums' does not include any policyholder dividends.

"(B) EXCEPTION FOR INDEMNITY REINSURANCE.—Subparagraph (A) shall not apply to amounts of premiums or other consideration returned to another life insurance company in respect of indemnity reinsurance.

"Subpart C—Life Insurance Deductions

"Sec. 804. Life insurance deductions.
"Sec. 805. General deductions.
"Sec. 806. Special deductions.
"Sec. 807. Rules for certain reserves.
"Sec. 808. Policyholder dividends deduction.
"Sec. 809. Reduction in certain deductions of mutual life insurance companies.
"Sec. 810. Operations loss deduction.

"SEC. 804. LIFE INSURANCE DEDUCTIONS.

"For purposes of this part, the term 'life insurance deductions' means—

"(1) the general deductions provided in section 805,

"(2) the special life insurance company deduction determined under section 806(a), and

"(3) the small life insurance company deduction (if any) determined under section 806(b).

"SEC. 805. GENERAL DEDUCTIONS.

"(a) GENERAL RULE.—For purposes of this part, there shall be allowed the following deductions:

"(1) DEATH BENEFITS, ETC.—All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts.

"(2) INCREASES IN CERTAIN RESERVES.—The net increase in reserves which is required by section 807(b) to be taken into account under this paragraph.

"(3) POLICYHOLDER DIVIDENDS.—The deduction for policyholder dividends (determined under section 808(c)).

"(4) DIVIDENDS RECEIVED BY COMPANY.—

"(A) IN GENERAL.—The deductions provided by sections 243, 244, and 245 (as modified by subparagraph (B))—

"(i) for 100 percent dividends received, and

"(ii) for the life insurance company's share of the dividends (other than 100 percent dividends) received.

"(B) APPLICATION OF SECTION 246(b).—In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of subparagraph (A), the limit on the aggregate amount of the deductions allowed by sections 243(a)(1), 244(a), and 245 shall be 85 percent of the life insurance company taxable income, computed without regard to—

"(i) the special life insurance company deduction and the small life insurance company deduction,

"(ii) the operations loss deduction provided by section 810,

"(iii) the deductions allowed by sections 243(a)(1), 244(a), and 245, and

"(iv) any capital loss carryback to the taxable year under section 1212(a)(1),

but such limit shall not apply for any taxable year for which there is a loss from operations.

"(C) 100 PERCENT DIVIDEND.—For purposes of subparagraph (A), the term '100 percent dividend' means any dividend if the percentage used for purposes of determining the deduction allowable under section 243 or 244 is 100 percent. Such term does not include any dividend to the extent it is a distribution out of tax-exempt interest or out of dividends which are not 100 percent dividends (determined with the application of this sentence).

"(D) CERTAIN DIVIDENDS RECEIVED IN THE CASE OF FOREIGN CORPORATIONS.—Subparagraph (A)(i) (and not subparagraph (A)(ii)) shall apply to any dividend which would be a 100 percent dividend if section 1504(b)(3) did not apply for purposes of applying section 243(b)(5).

"(5) OPERATIONS LOSS DEDUCTION.—The operations loss deduction (determined under section 810).

"(6) ASSUMPTION BY ANOTHER PERSON OF LIABILITIES UNDER INSURANCE, ETC., CONTRACTS.—The consideration (other than consideration arising out of indemnity reinsurance) in respect of the assumption by another person of liabilities under insurance and annuity contracts.

"(7) Reimbursable dividends.—The amount of policyholder dividends which—

"(A) are paid or accrued by another insurance company in respect of policies the taxpayer has reinsured, and

"(B) are reimbursable by the taxpayer under the terms of the reinsurance contract.

"(8) Other deductions.—Subject to the modifications provided by subsection (b), all other deductions allowed under this subtitle for purposes of computing taxable income.

Except as provided in paragraph (3), no amount shall be allowed as a deduction under this part in respect of policyholder dividends.

"(b) Modifications.—The modifications referred to in subsection (a)(8) are as follows:

"(1) Interest.—In applying section 163 (relating to deduction for interest), no deduction shall be allowed for interest in respect of items described in section 807(c).

"(2) Bad debts.—Section 166(c) (relating to reserve for bad debts) shall not apply.

"(3) Charitable, etc., contributions and gifts.—In applying section 170—

"(A) the limit on the total deductions under such section provided by section 170(b)(2) shall be 10 percent of the life insurance company taxable income computed without regard to—

"(i) the deduction provided by section 170,

"(ii) the deductions provided by paragraphs (3) and (4) of subsection (a),

"(iii) the special life insurance company deduction and the small life insurance company deduction,

"(iv) any operations loss carryback to the taxable year under section 810, and

"(v) any capital loss carryback to the taxable year under section 1212(a)(1), and

"(B) under regulations prescribed by the Secretary, a rule similar to the rule contained in section 170(d)(2)(B) (relating to special rule for net operating loss carryovers) shall be applied.

"(4) AMORTIZABLE BOND PREMIUM.—

"(A) IN GENERAL.—Section 171 shall not apply.

"(B) CROSS REFERENCE.—

"For rules relating to amortizable bond premium, see section 811(b).

"(5) NET OPERATING LOSS DEDUCTION.—Except as provided by section 844, the deduction for net operating losses provided in section 172 shall not be allowed.

"(6) DIVIDENDS RECEIVED DEDUCTION.—Except as provided in subsection (a)(4), the deductions for dividends received provided by sections 243, 244, and 245 shall not be allowed.

"SEC. 806. SPECIAL DEDUCTIONS.

"(a) SPECIAL LIFE INSURANCE COMPANY DEDUCTION.—For purposes of section 804, the special life insurance company deduction for any taxable year is 25 percent of the excess of the tentative LICTI for such taxable year over the small life insurance company deduction (if any).

"(b) SMALL LIFE INSURANCE COMPANY DEDUCTION.—

"(1) IN GENERAL.—For purposes of section 804, the small life insurance company deduction for any taxable year is 60 percent of so much of the tentative LICTI for such taxable year as does not exceed $3,000,000.

"(2) PHASEOUT BETWEEN $3,000,000 AND $15,000,000.—The amount of the small life insurance company deduction determined under paragraph (1) for any taxable year shall be reduced (but not below zero) by 15 percent of so much of the tentative LICTI for such taxable year as exceeds $3,000,000.

"(3) SMALL LIFE INSURANCE COMPANY DEDUCTION NOT ALLOWABLE TO COMPANY WITH ASSETS OF $500,000,000 OR MORE.—

"(A) IN GENERAL.—The small life insurance company deduction shall not be allowed for any taxable year to any life insurance company which, at the close of such taxable year, has assets equal to or greater than $500,000,000.

"(B) ASSETS.—For purposes of this paragraph, the term 'assets' means all assets of the company.

"(C) VALUATION OF ASSETS.—For purposes of this paragraph, the amount attributable to—

"(i) real property and stock shall be the fair market value thereof, and

"(ii) any other asset shall be the adjusted basis of such asset for purposes of determining gain on sale or other disposition.

"(D) SPECIAL RULE FOR INTERESTS IN PARTNERSHIPS AND TRUSTS.—For purposes of this paragraph—

"(i) an interest in a partnership or trust shall not be treated as an asset of the company, but

"(ii) the company shall be treated as actually owning its proportionate share of the assets held by the partnership or trust (as the case may be).

"(c) Tentative LICTI.—For purposes of this part—

"(1) In general.—The term 'tentative LICTI' means life insurance company taxable income determined without regard to—

"(A) the special life insurance company deduction, and

"(B) the small life insurance company deduction.

"(2) Exclusion of items attributable to noninsurance businesses.—The amount of the tentative LICTI for any taxable year shall be determined without regard to all items attributable to noninsurance businesses.

"(3) Noninsurance business.—

"(A) In general.—The term 'noninsurance business' means any trade or business which is not an insurance business.

"(B) CERTAIN BUSINESSES TREATED AS INSURANCE BUSINESSES.—For purposes of subparagraph (A), any business which is not an insurance business but is of a type traditionally carried on by life insurance companies for investment purposes shall be treated as an insurance business.

"(d) SPECIAL RULE FOR CONTROLLED GROUPS.—

"(1) SPECIAL LIFE INSURANCE COMPANY DEDUCTION AND SMALL LIFE INSURANCE COMPANY DEDUCTION DETERMINED ON CONTROLLED GROUP BASIS.—For purposes of subsections (a) and (b)—

"(A) all life insurance companies which are members of the same controlled group shall be treated as 1 life insurance company, and

"(B) any special life insurance company deduction and any small life insurance company deduction determined with respect to such group shall be allocated among the life insurance companies which are members of such group in proportion to their respective tentative LICTI's.

"(2) NONLIFE INSURANCE MEMBERS INCLUDED FOR ASSET TEST.—For purposes of subsection (b)(3), all members of the same controlled group (whether or not life insurance companies) shall be treated as 1 company.

"(3) CONTROLLED GROUP.—For purposes of this subsection, the term 'controlled group' means any controlled group of corporations (as defined in section 1563(a)); except that subsections (a)(4) and (b)(2)(D) of section 1563 shall not apply.

"(4) NO DOUBLE COUNTING OF LOSS.—Under regulations prescribed by the Secretary, proper adjustments shall be made in the application of this subsection so that a loss from operations of any member of a controlled group will reduce the tentative LICTI of such group only once.

"SEC. 807. RULES FOR CERTAIN RESERVES.

"(a) DECREASE TREATED AS GROSS INCOME.—If for any taxable year—

"(1) the opening balance for the items described in subsection (c), exceeds

"(2)(A) the closing balance for such items, reduced by

"(B) the sum of (i) the amount of the policyholders' share of tax-exempt interest, plus (ii) any excess described in section 809(a)(2) for the taxable year,

such excess shall be included in gross income under section 803(a)(2).

"(b) INCREASE TREATED AS DEDUCTION.—If for any taxable year—

"(1)(A) the closing balance for the items described in subsection (c), reduced by

"(B) the sum of (i) the amount of the policyholders' share of tax-exempt interest, plus (ii) any excess described in section 809(a)(2) for the taxable year, exceeds

"(2) the opening balance for such items,

such excess shall be taken into account as a deduction under section 805(a)(2).

"(c) ITEMS TAKEN INTO ACCOUNT.—The items referred to in subsections (a) and (b) are as follows:

"(1) The life insurance reserves (as defined in section 816(b)).

"(2) The unearned premiums and unpaid losses included in total reserves under section 816(c)(2).

"(3) The amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, accident, or health contingencies.

"(4) Dividend accumulations, and other amounts, held at interest in connection with insurance and annuity contracts.

"(5) Premiums received in advance, and liabilities for premium deposit funds.

"(6) Reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

For purposes of paragraph (3), the appropriate rate of interest for any obligation is the higher of the prevailing State assumed interest rate as of the time such obligation first did not involve life, accident, or health contingencies or the rate of interest assumed by the company (as of such time) in determining the guaranteed benefit.

"(d) METHOD OF COMPUTING RESERVES FOR PURPOSES OF DETERMINING INCOME.—

"(1) IN GENERAL.—For purposes of this part (other than section 816), the amount of the life insurance reserves for any contract shall be the greater of—

"(A) the net surrender value of such contract, or

"(B) the reserve determined under paragraph (2).

In no event shall the reserve determined under the preceding sentence for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves (as defined in section 809(b)(4)(B)).

"(2) AMOUNT OF RESERVE.—The amount of the reserve determined under this paragraph with respect to any contract shall be determined by using—

"(A) the tax reserve method applicable to such contract,

"(B) the prevailing State assumed interest rate, and

"(C) the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

"(3) TAX RESERVE METHOD.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'tax reserve method' means—

"(i) LIFE INSURANCE CONTRACTS.—The CRVM in the case of a contract covered by the CRVM.

"(ii) ANNUITY CONTRACTS.—The CARVM in the case of a contract covered by the CARVM.

"(iii) NONCANCELLABLE ACCIDENT AND HEALTH INSURANCE CONTRACTS.—In the case of any noncancellable accident and health insurance contract, a 2-year full preliminary term method.

"(iv) OTHER CONTRACTS.—In the case of any contract not described in clause (i), (ii), or (iii)—

"(I) the reserve method prescribed by the National Association of Insurance Commissioners which covers such contract (as of the date of issuance), or

"(II) if no reserve method has been prescribed by the National Association of Insurance Commissioners which covers such contract, a reserve method which is consistent with the reserve method required under clause (i), (ii), or (iii) or under subclause (I) of this clause as of the date of the issuance of such contract (whichever is most appropriate).

"(B) DEFINITION OF CRVM AND CARVM.—For purposes of this paragraph—

"(i) CRVM.—The term 'CRVM' means the Commissioners' Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract.

"(ii) CARVM.—The term 'CARVM' means the Commissoners' Annuities Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract.

"(4) PREVAILING STATE ASSUMED INTEREST RATE.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'prevailing State assumed interest rate' means, with respect to any contract, the highest assumed interest rate permitted to be used in computing life insurance reserves for insurance contracts or annuity contracts (as the case may be) under the insurance laws of at least 26 States. For purposes of the preceding sentence, the effect of the nonforfeiture laws of a State on interest rates for reserves shall not be taken into account.

"(B) WHEN RATE DETERMINED.—Except as provided in subparagraph (C), the prevailing State assumed rate with respect to any contract shall be determined as of the beginning of the calendar year in which the contract was issued.

"(C) ELECTION FOR NONANNUITY CONTRACTS.—In the case of a contract other than an annuity contract, the issuer may elect (at such time and in such manner as the Secretary shall by regulations prescribe) to determine the prevailing State assumed rate as of the beginning of the calendar year preceding the calendar year in which the contract was issued.

"(5) PREVAILING COMMISSIONERS' STANDARD TABLES.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'prevailing commissioners' standard tables' means, with respect to any contract, the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued.

"(B) INSURER MAY USE OLD TABLES FOR 3 YEARS WHEN TABLES CHANGE.—If the prevailing commissioners' standard tables as of the beginning of any calendar year (hereinafter in this subparagraph referred to as the 'year of change') is different from the prevailing commissioners' standard tables as of the beginning of the preceding calendar year, the issuer may use the prevailing commissioners' standard tables as of the beginning of the preceding calendar year with respect to any contract issued after the change and before the close of the 3-year period beginning on the first day of the year of change.

"(C) SPECIAL RULE FOR CONTRACTS FOR WHICH THERE ARE NO COMMISSIONERS' STANDARD TABLES.—If there are no commissioners' standard tables applicable to any contract when it is issued, the mortality and morbidity tables used for purposes of paragraph (2)(C) shall be determined under regulations prescribed by the Secretary.

"(D) SPECIAL RULE FOR CONTRACTS ISSUED BEFORE 1948.—If—

"(i) a contract was issued before 1948, and "(ii) there were no commissioners' standard tables applicable to such contract when it was issued,

the mortality and morbidity tables used in computing statutory reserves for such contracts shall be used for purposes of paragraph (2)(C).

"(E) SPECIAL RULE WHERE MORE THAN 1 TABLE OR OPTION APPLICABLE.—If, with respect to any category of risks, there are 2 or more tables (or options under 1 or more tables) which meet the requirements of subparagraph (A) (or, where applicable, subparagraph (B) or (C)), the table (and option thereunder) which generally yields the lowest reserves shall be used for purposes of paragraph (2)(C).

"(e) SPECIAL RULES FOR COMPUTING RESERVES.—

"(1) NET SURRENDER VALUE.—For purposes of this section—

"(A) IN GENERAL.—The net surrender value of any contract shall be determined—

"(i) with regard to any penalty or charge which would be imposed on surrender, but

"(ii) without regard to any market value adjustment on surrender.

"(B) SPECIAL RULE FOR PENSION PLAN CONTRACTS.—In the case of a pension plan contract, the balance in the policyholder's fund (determined without regard to any market value adjustment) shall be treated as the net surrender value of such contract.

"(2) ISSUANCE DATE IN CASE OF GROUP CONTRACTS.—For purposes of this section, in the case of a group contract, the date on which such contract is issued shall be the date as of which the master plan is issued (or, with respect to a benefit guaranteed to a participant after such date, the date as of which such benefit is guaranteed).

"(3) SUPPLEMENTAL BENEFITS.—

"(A) QUALIFIED SUPPLEMENTAL BENEFITS TREATED SEPARATELY.—For purposes of this part, the amount of the life insurance reserve for any qualified supplemental benefit—

"(i) shall be computed separately as though such benefit were under a separate contract, and

"(ii) shall, except to the extent otherwise provided in regulations, be the reserve taken into account for purposes of the annual statement approved by the National Association of Insurance Commissioners.

"(B) SUPPLEMENTAL BENEFITS WHICH ARE NOT QUALIFIED SUPPLEMENTAL BENEFITS.—In the case of any supplemental benefit described in subparagraph (D) which is not a qualified supplemental benefit, the amount of the reserve determined under paragraph (2) of subsection (d) shall, except to the extent otherwise provided in regulations, be the reserve taken into account for purposes of the annual statement approved by the National Association of Insurance Commissioners.

"(C) QUALIFIED SUPPLEMENTAL BENEFIT.—For purposes of this paragraph, the term 'qualified supplemental benefit' means any supplemental benefit described in subparagraph (D) if—

"(i) there is a separately identified premium or charge for such benefit, and

"(ii) any net surrender value under the contract attributable to any other benefit is not available to fund such benefit.

"(D) SUPPLEMENTAL BENEFITS.—For purposes of this paragraph, the supplemental benefits described in this subparagraph are any—

"(i) guaranteed insurability,

"(ii) accidental death or disability benefit,

"(iii) convertibility,

"(iv) disability waiver benefit, or

"(v) other benefit prescribed by regulations,

which is supplemental to a contract for which there is a reserve described in subsection (c).

"(4) CERTAIN CONTRACTS ISSUED BY FOREIGN BRANCHES OF DOMESTIC LIFE INSURANCE COMPANIES.—

"(A) IN GENERAL.—In the case of any qualified foreign contract, the amount of the reserve shall be not less than the minimum reserve required by the laws, regulations, or administrative guidance of the regulatory authority of the foreign country referred to in subparagraph (B) (but not to exceed the net level reserves for such contract).

"(B) QUALIFIED FOREIGN CONTRACT.—For purposes of subparagraph (A), the term 'qualified foreign contract' means any contract issued by a foreign life insurance branch (which has its principal place of business in a foreign country) of a domestic life insurance company if—

"(i) such contract is issued on the life or health of a resident of such country,

"(ii) such domestic life insurance company was required by such foreign country (as of the time it began operations in such country) to operate in such country through a branch, and

"(iii) such foreign country is not contiguous to the United States.

"(5) TREATMENT OF SUBSTANDARD RISKS.—

"(A) SEPARATE COMPUTATION.—Except to the extent provided in regulations, the amount of the life insurance reserve for any qualified substandard risk shall be computed separately under subsection (d)(1) from any other reserve under the contract.

"(B) QUALIFIED SUBSTANDARD RISK—For purposes of subparagraph (A), the term qualified substandard risk' means any substandard risk if—

"(i) the insurance company maintains a separate reserve for such risk,

"(ii) there is a separately identified premium or charge for such risk, "(iii) the amount of the net surrender value under the contract is not increased or decreased by reason of such risk, and

"(iv) the net surrender value under the contract is not regularly used to pay premium charges for such risk.

"(C) LIMITATION ON AMOUNT OF LIFE INSURANCE RESERVE.—The amount of the life insurance reserve determined for any qualified substandard risk shall in no event exceed the sum of the separately identified premiums charged for such risk plus interest less mortality charges for such risk.

"(D) LIMITATION ON AMOUNT OF CONTRACTS TO WHICH PARAGRAPH APPLIES.—The aggregate amount of insurance in force under contracts to which this paragraph applies shall not exceed 10 percent of the insurance in force (other than term insurance) under life insurance contracts of the company.

"(f) ADJUSTMENT FOR CHANGE IN COMPUTING RESERVES.—

"(1) 10-YEAR SPREAD.—

"(A) IN GENERAL.—For purposes of this part, if the basis for determining any item referred to in subsection (c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between—

"(i) the amount of the item at the close of the taxable year, computed on the new basis, and

"(ii) the amount of the item at the close of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account under the method provided in subparagraph (B).

"(B) METHOD.—The method provided in this subparagraph is as follows:

"(i) if the amount determined under subparagraph (A)(i) exceeds the amount determined under subparagraph (A)(ii), 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years, as a deduction under section 805(a)(2); or

"(ii) if the amount determined under subparagraph (A)(ii) exceeds the amount determined under subparagraph (A)(i), 1/10 of such excess shall be included in gross income, for each of the 10 succeeding taxable years, under section 803(a)(2).

"(2) TERMINATION AS LIFE INSURANCE COMPANY.—Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), if for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments under this subsection shall be taken into account for the preceding taxable year.

"SEC. 808. POLICYHOLDER DIVIDENDS DEDUCTION.

"(a) POLICYHOLDER DIVIDEND DEFINED.—For purposes of this part, the term 'policyholder dividend' means any dividend or similar distribution to policyholders in their capacity as such.

"(b) CERTAIN AMOUNTS INCLUDED.—For purposes of this part, the term 'policyholder dividend' includes—

"(1) any amount paid or credited (including as an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management,

"(2) excess interest,

"(3) premium adjustments, and

"(4) experience-rated refunds.

"(c) AMOUNT OF DEDUCTION.—

"(1) IN GENERAL.—Except as limited by paragraph (2), the deduction for policyholder dividends for any taxable year shall be an amount equal to the policyholder dividends paid or accrued during the taxable year.

"(2) REDUCTION IN CASE OF MUTUAL COMPANIES.—In the case of a mutual life insurance company, the deduction for policyholder dividends for any taxable year shall be reduced by the amount determined under section 809.

"(d) DEFINITIONS.—For purposes of this section—

"(1) EXCESS INTEREST.—The term 'excess interest' means any amount in the nature of interest—

"(A) paid or credited to a policyholder in his capacity as such, and

"(B) determined at a rate in excess of the prevailing State assumed interest rate for such contract.

"(2) PREMIUM ADJUSTMENT.—The term 'premium adjustment' means any reduction in the premium under an insurance or annuity contract which (but for the reduction) would have been required to be paid under the contract.

"(3) EXPERIENCE-RATED REFUND.—The term 'experience-rated refund' means any refund or credit based on the experience of the contract or group involved.

"(e) TREATMENT OF POLICYHOLDER DIVIDENDS.—For purposes of this part, any policyholder dividend which—

"(1) increases the cash surrender value of the contract or other benefits payable under the contract, or

"(2) reduces the premium otherwise required to be paid,

shall be treated as paid to the policyholder and returned by the policyholder to the company as a premium.

"SEC. 809. REDUCTION IN CERTAIN DEDUCTIONS OF MUTUAL LIFE INSURANCE COMPANIES.

"(a) GENERAL RULE.—

"(1) POLICYHOLDER DIVIDENDS.—In the case of any mutual life insurance company, the amount of the deduction allowed under section 808 shall be reduced (but not below zero) by the differential earnings amount.

"(2) REDUCTION IN RESERVE DEDUCTION IN CERTAIN CASES.—In the case of any mutual life insurance company, if the differential earnings amount exceeds the amount allowable as a deduction under section 808 for the taxable year (determined without regard to this section), such excess shall be taken into account under subsections (a) and (b) of section 807.

"(3) DIFFERENTIAL EARNINGS AMOUNT.—For purposes of this section, the term 'differential earnings amount' means, with respect to any taxable year, an amount equal to the product of—

"(A) the life insurance company's average equity base for the taxable year, multiplied by

"(B) the differential earnings rate for such taxable year.

"(b) AVERAGE EQUITY BASE.—For purposes of this section—

"(1) IN GENERAL.—The term 'average equity base' means, with respect to any taxable year, the average of—

"(A) the equity base determined as of the close of the taxable year, and

"(B) the equity base determined as of the close of the preceding taxable year.

"(2) EQUITY BASE.—The term 'equity base' means an amount equal to—

"(A) the surplus and capital,

"(B) adjusted as provided in paragraphs (3), (4), (5), and (6) of this subsection.

"(3) INCREASE FOR NONADMITTED FINANCIAL ASSETS.—

"(A) IN GENERAL.—The amount of the surplus and capital shall be increased by the amount of the nonadmitted financial assets.

"(B) NONADMITTED FINANCIAL ASSETS.—For purposes of subparagraph (A), the term 'nonadmitted financial asset' means any nonadmitted asset of the company which is—

"(i) a bond,

"(ii) stock,

"(iii) real estate,

"(iv) a mortgage loan on real estate, or

"(v) any other invested asset.

"(4) INCREASE WHERE STATUTORY RESERVES EXCEED TAX RESERVES.—

"(A) IN GENERAL.—If—

"(i) the aggregate amount of statutory reserves, exceeds

"(ii) the aggregate amount of tax reserves,

the amount of the surplus and capital shall be increased by the amount of such excess.

"(B) DEFINITIONS.—For purposes of this paragraph—

"(i) STATUTORY RESERVES.—The term 'statutory reserves' means the aggregate amount set forth in the annual statement with respect to items described in section 807(c). Such term shall not include any reserve attributable to a deferred and uncollected premium if the establishment of such reserve is not permitted under section 811(c).

"(ii) TAX RESERVES.—The term 'tax reserves' means the aggregate of the items described in section 807(c) as determined for purposes of section 807.

"(5) INCREASE BY AMOUNT OF CERTAIN OTHER RESERVES.—The amount of the surplus and capital shall be increased by the sum of—

"(A) the amount of any mandatory securities valuation reserve,

"(B) the amount of any deficiency reserve, and

"(C) the amount of any voluntary reserve not described in subparagraph (A) or (B).

"(6) ADJUSTMENT FOR NEXT YEAR'S POLICYHOLDER DIVIDENDS.—The amount of the surplus and capital shall be increased by 50 percent of the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year.

"(c) DIFFERENTIAL EARNINGS RATE.—For purposes of this section, the differential earnings rate for any taxable year is the excess of—

"(1) the imputed earnings rate for the taxable year, over

"(2) the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins.

"(d) IMPUTED EARNINGS RATE.—

"(1) IN GENERAL.—For purposes of this section, the imputed earnings rate for any taxable year is—

"(A) 16.5 percent in the case of taxable years beginning in 1984, and

"(B) in the case of taxable years beginning after 1984, an amount which bears the same ratio to 16.5 percent as the current stock earnings rate for the taxable year bears to the base period stock earnings rate.

"(2) CURRENT STOCK EARNINGS RATE.—For purposes of this subsection, the term 'current stock earnings rate' means, with respect to any taxable year, the average of the stock earnings rates determined under paragraph (4) for the 3 calendar years preceding the calendar year in which the taxable year begins.

"(3) BASE PERIOD STOCK EARNINGS RATE.—For purposes of this subsection, the base period stock earnings rate is the average of the stock earnings rates determined under paragraph (4) for calendar years 1981, 1982, and 1983.

"(4) STOCK EARNINGS RATE.—

"(A) IN GENERAL.—For purposes of this subsection, the stock earnings rate for any calendar year is the numerical average of the earnings rates of the 50 largest stock companies.

"(B) EARNINGS RATE.—For purposes of subparagraph (A), the earnings rate of any stock company is the percentage (determined by the Secretary) which—

"(i) the statement gain or loss from operations for the calendar year of such company, is of

"(ii) such company's average equity base for such year.

"(C) 50 LARGEST STOCK COMPANIES.—For purposes of this paragraph, the term '50 largest stock companies' means a group (as determined by the Secretary) of stock life insurance companies which consists of the 50 largest stock life insurance companies which are subject to tax under this chapter.

"(D) TREATMENT OF AFFILIATED GROUPS.—For purposes of this paragraph, all stock life insurance companies which are members of the same affiliated group shall be treated as one stock life insurance company.

"(e) AVERAGE MUTUAL EARNINGS RATE.—For purposes of this section, the average mutual earnings rate for any calendar year is the percentage (determined by the Secretary) which—

"(1) the aggregate statement gain or loss from operations for such year of mutual life insurance companies, is of

"(2) their aggregate average equity bases for such year.

"(f) RECOMPUTATION IN SUBSEQUENT YEAR.—

"(1) INCLUSION IN INCOME WHERE RECOMPUTED AMOUNT GREATER.—In the case of any mutual life insurance company, if—

"(A) the recomputed differential earnings amount for any taxable year, exceeds

"(B) the differential earnings amount determined under this section for such taxable year, such excess shall be included in life insurance gross income for the succeeding taxable year.

"(2) DEDUCTION WHERE RECOMPUTED AMOUNT SMALLER.—In the case of any mutual life insurance company, if—

"(A) the differential earnings amount determined under this section for any taxable year, exceeds

"(B) the recomputed differential earnings amount for such taxable year,

such excess shall be allowed as a life insurance deduction for the succeeding taxable year.

"(3) RECOMPUTED DIFFERENTIAL EARNINGS AMOUNT.—For purposes of this subsection, the term 'recomputed differential earnings amount' means, with respect to any taxable year, the amount which would be the differential earnings amount for such taxable year if the average mutual earnings rate taken into account under subsection (c)(2) were the average mutual earnings rate for the calendar year in which the taxable year begins.

"(4) SPECIAL RULE WHERE COMPANY CEASES TO BE MUTUAL LIFE INSURANCE COMPANY.—Except as provided in section 381(c)(22), if—

"(A) a life insurance company is a mutual life insurance company for any taxable year, but

"(B) such life insurance company is not a mutual life insurance company for the succeeding taxable year,

any adjustment under paragraph (1) or (2) by reason of the recomputed differential earnings amount for the first of such taxable years shall be taken into account for the first of such taxable years.

"(g) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) STATEMENT GAIN OR LOSS FROM OPERATIONS.—The term 'statement gain or loss from operations' means the net gain or loss from operations required to be set forth in the annual statement—

"(A) determined with regard to policyholder dividends (as defined in section 808) but without regard to Federal income taxes,

"(B) determined on the basis of the tax reserves rather than statutory reserves, and

"(C) properly adjusted for realized capital gains and losses and other relevant items.

"(2) OTHER TERMS.—Except as otherwise provided in this section, the terms used in this section shall have the same respective meanings as when used in the annual statement.

"(3) DETERMINATIONS BASED ON AMOUNT SET FORTH IN ANNUAL STATEMENT.—Except as otherwise provided in this section or in regulations, all determinations under this section shall be made on the basis of the amounts required to be set forth on the annual statement.

"(4) ANNUAL STATEMENT.—The term 'annual statement' means the annual statement for life insurance companies approved by the National Association of Insurance Commissioners.

"(5) REDUCTION IN EQUITY BASE FOR PORTION OF EQUITY ALLOCABLE TO LIFE INSURANCE BUSINESS IN NONCONTIGUOUS WESTERN HEMISPHERE COUNTRIES.—The equity base of any mutual life insurance company shall be reduced by an amount equal to the portion of the equity base attributable to the life insurance business multiplied by a fraction—

"(A) the numerator of which is the portion of the tax reserves which is allocable to life insurance contracts issued on the life of residents of countries in the Western Hemisphere which are not contiguous to the United States, and

"(B) the denominator of which is the amount of the tax reserves allocable to life insurance contracts.

The preceding sentence shall not apply unless the fraction determined under the preceding sentence exceeds ½0.

"(h) TREATMENT OF STOCK COMPANIES OWNED BY MUTUAL LIFE INSURANCE COMPANIES.—

"(1) TREATMENT AS MUTUAL LIFE INSURANCE COMPANIES FOR PURPOSES OF DETERMINING STOCK EARNINGS RATES AND MUTUAL EARNINGS RATES.—Solely for purposes of subsections (d) and (e), a stock life insurance company shall be treated as a mutual life insurance company if stock possessing—

"(A) at least 80 percent of the total combined voting power of all classes of stock of such stock life insurance company entitled to vote, or

"(B) at least 80 percent of the total value of shares of all classes of stock of such stock life insurance company,

is owned at any time during the calendar year directly (or through the application of section 318) by 1 or more mutual life insurance companies.

"(2) TREATMENT OF AFFILIATED GROUP WHICH INCLUDES MUTUAL PARENT AND STOCK SUBSIDI-

ARY.—In the case of an affiliated group of corporations which includes a common parent which is a mutual life insurance company and one or more stock life insurance companies, for purposes of determining the average equity base of such common parent (and the statement gain or loss from operations)—

"(A) stock in such stock life insurance companies held by such common parent (and dividends on such stock) shall not be taken into account, and

"(B) such common parent and such stock life insurance companies shall be treated as though they were one mutual life insurance company.

"(3) ADJUSTMENT WHERE STOCK COMPANY NOT MEMBER OF AFFILIATED GROUP.—In the case of any stock life insurance company which is described in paragraph (1) but is not a member of an affiliated group described in paragraph (2), under regulations, proper adjustments shall be made in the average equity bases (and statement gains or losses from operations) of mutual life insurance companies owning stock in such company as may be necessary or appropriate to carry out the purposes of this section.

"(i) TRANSITIONAL RULE FOR CERTAIN HIGH SURPLUS MUTUAL LIFE INSURANCE COMPANIES.—

"(1) IN GENERAL.—For purposes of subsection (a)(3), the average equity base of a high surplus mutual life insurance company for any taxable year shall not include the applicable percentage of the excess equity base of such company for such taxable year.

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) EXCESS EQUITY BASE.—The term 'excess equity base' means the lesser of—

"(i) the excess of—

"(I) the average equity base of the company for the taxable year, over

"(II) the amount which would be its average equity base if its equity percentage equaled 130 percent of the numerical average of the equity percentages for all mutual life insurance companies for such taxable year, or

"(ii) $50,000,000.

"(B) APPLICABLE PERCENTAGE.—The term 'applicable percentage' means the percentage determined in accordance with the following table:

"For taxable years beginning in:	The applicable percentage is:
1984	100
1985	80
1986	60
1987	40
1988	20
1989 or thereafter	0.

"(C) HIGH SURPLUS MUTUAL LIFE INSURANCE COMPANY.—The term 'high surplus mutual life insurance company' means any mutual life insurance company if, for the taxable year beginning in 1984, its equity percentage exceeded 130 percent of the numerical average of the equity percentages for all mutual life insurance companies for such taxable year.

"(D) EQUITY PERCENTAGE.—The term 'equity percentage' means, with respect to any mutual life insurance company, the percentage which—

"(i) the average equity base of such company (determined under this section without regard to this subsection) for a taxable year bears to

"(ii) the average of—

"(I) the assets of such company as of the close of the preceding taxable year, and

"(II) the assets of such company as of the close of the taxable year.

For purposes of the preceding sentence, the assets of a company shall include all assets included under this section in its equity base.

"(3) DETERMINATION OF AVERAGE OF EQUITY PERCENTAGES FOR ALL COMPANIES.—The average of the equity percentages for all mutual life insurance companies for any taxable year shall be such average as determined by the Secretary using the most recent data available as of the close of such taxable year.

"SEC. 810. OPERATIONS LOSS DEDUCTION.

"(a) DEDUCTION ALLOWED.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of—

"(1) the operations loss carryovers to such year, plus

"(2) the operations loss carrybacks to such year.

For purposes of this part, the term 'operations loss deduction' means the deduction allowed by this subsection.

"(b) OPERATIONS LOSS CARRYBACKS AND CARRYOVERS.—

"(1) YEARS TO WHICH LOSS MAY BE CARRIED.—The loss from operations for any taxable year (hereinafter in this section referred to as the 'loss year') shall be—

"(A) an operations loss carryback to each of the 3 taxable years preceding the loss year,

"(B) an operations loss carryover to each of the 15 taxable years following the loss year, and

"(C) if the life insurance company is a new company for the loss year, an operations loss carryover to each of the 3 taxable years following the 15 taxable years described in subparagraph (B).

"(2) AMOUNT OF CARRYBACKS AND CARRYOVERS.—The entire amount of the loss from operations for any loss year shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess (if any) of the amount of such loss over the sum of the offsets (as defined in subsection (d)) for each of the prior taxable years to which such loss may be carried.

"(3) ELECTION FOR OPERATIONS LOSS CARRYBACKS.—In the case of a loss from operations for any taxable year, the taxpayer may elect to relinquish the entire carryback period for such loss. Such election shall be made by the due date (including extensions of time) for filing the return for the taxable year of the loss from operations for which the election is to be in effect, and, once made for any taxable year, such election shall be irrevocable for that taxable year.

"(c) COMPUTATION OF LOSS FROM OPERATIONS.—For purposes of this section—

"(1) IN GENERAL.—The term 'loss from operations' means the excess of the life insurance deductions for any taxable year over the life insurance gross income for such taxable year.

"(2) MODIFICATIONS.—For purposes of paragraph (1)—

"(A) the operations loss deduction shall not be allowed, and

"(B) the deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) as modified by section 805(a)(4).

"(d) OFFSET DEFINED.—

"(1) IN GENERAL.—For purposes of subsection (b)(2), the term 'offset' means, with respect to any taxable year, an amount equal to that increase in the operations loss deduction for the taxable year which reduces the life insurance company taxable income (computed without regard to paragraphs (2) and (3) of section 804) for such year to zero.

"(2) OPERATIONS LOSS DEDUCTION.—For purposes of paragraph (1), the operations loss deduction for any taxable year shall be computed without regard to the loss from operations for the loss year or for any taxable year thereafter.

"(e) NEW COMPANY DEFINED.—For purposes of this part, a life insurance company is a new company for any taxable year only if such taxable year begins not more than 5 years after the first day on which it (or any predecessor, if section 381(c)(22) applies) was authorized to do business as an insurance company.

"(f) APPLICATION OF SUBTITLES A AND F IN RESPECT OF OPERATION LOSSES.—Except as provided in section 805(b)(5), subtitles A and F shall apply in respect of operation loss carrybacks, operation loss carryovers, and the operations loss deduction under this part, in the same manner and to the same extent as such subtitles apply in respect of net operating loss carrybacks, net operating loss carryovers, and the net operating loss deduction.

"(g) TRANSITIONAL RULE.—For purposes of this section and section 812 (as in effect before the enactment of the Life Insurance Tax Act of 1984), this section shall be treated as a continuation of such section 812.

"Subpart D—Accounting, Allocation, and Foreign Provisions

"Sec. 811. Accounting provisions.
"Sec. 812. Definition of company's share and policyholders' share.
"Sec. 813. Foreign life insurance companies.
"Sec. 814. Contiguous country branches of domestic life insurance companies.
"Sec. 815. Distributions to shareholders from pre-1984 policyholders surplus account.

"SEC. 811. ACCOUNTING PROVISIONS.

"(a) METHOD OF ACCOUNTING.—All computations entering into the determination of the taxes imposed by this part shall be made—

"(1) under an accrual method of accounting, or

"(2) to the extent permitted under regulations prescribed by the Secretary, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

To the extent not inconsistent with the preceding sentence or any other provision of this part, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

"(b) AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—

"(1) IN GENERAL.—The appropriate items of income, deductions, and adjustments under this part shall be adjusted to reflect the appropriate amortization of premium and the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined—

"(A) in accordance with the method regularly employed by such company, if such method is reasonable, and

"(B) in all other cases, in accordance with regulations prescribed by the Secretary.

"(2) SPECIAL RULES.—

"(A) AMORTIZATION OF BOND PREMIUM.—In the case of any bond (as defined in section 171(d)), the amount of bond premium, and the amortizable bond premium for the taxable year, shall be determined under section 171(b) as if the election set forth in section 171(c) had been made.

"(B) CONVERTIBLE EVIDENCE OF INDEBTEDNESS.—In no case shall the amount of premium on a convertible evidence of indebtedness include any amount attributable to the conversion features of the evidence of indebtedness.

"(3) EXCEPTION.—No accrual of discount shall be required under paragraph (1) on any bond (as defined in section 171(d)), except in the case of discount which is—

"(A) interest to which section 103 applies, or

"(B) original issue discount (as defined in section 1232(b)).

"(c) NO DOUBLE COUNTING.—Nothing in this part shall permit—

"(1) a reserve to be established for any item unless the gross amount of premiums and other consideration attributable to such item are required to be included in life insurance gross income,

"(2) the same item to be counted more than once for reserve purposes, or

"(3) any item to be deducted (either directly or as an increase in reserves) more than once.

"(d) ALLOCATION IN CASE OF REINSURANCE AGREEMENT INVOLVING TAX AVOIDANCE OR EVASION.—In the case of 2 or more related persons (within the meaning of section 482) who are parties to a reinsurance agreement (or where one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of, or conduit for, another party to such agreement), the Secretary may—

"(1) allocate between or among such persons income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and other items related to such agreement, or

"(2) recharacterize any such items,

if he determines that such allocation or recharacterization is necessary to reflect the proper source and character of the taxable income (or any item described in paragraph (1) relating to such taxable income) of each such person.

"(e) METHOD OF COMPUTING RESERVES ON CONTRACT WHERE INTEREST IS GUARANTEED BEYOND END OF TAXABLE YEAR.—For purposes of this part (other than section 816), amounts in the nature of interest to be paid or credited under any contract for any period which is computed at a rate which—

"(1) exceeds the prevailing State assumed interest rate for the contract for such period, and

"(2) is guaranteed beyond the end of the taxable year on which the reserves are being computed,

shall be taken into account in computing the reserves with respect to such contract as if such interest were guaranteed only up to the end of the taxable year.

"(f) SHORT TAXABLE YEARS.—If any return of a corporation made under this part is for a period of less than the entire calendar year (referred to in this subsection as 'short period'), then section 443 shall not apply in respect to such period, but life insurance company taxable income shall be determined, under regulations prescribed by the Secretary, on an annual basis by a ratable daily projection of the appropriate figures for the short period.

"SEC. 812. DEFINITION OF COMPANY'S SHARE AND POLICYHOLDERS' SHARE.

"(a) GENERAL RULE.—

"(1) COMPANY'S SHARE.—For purposes of section 805(a)(4), the term 'company's share' means, with respect to any taxable year, the percentage obtained by dividing—

"(A) the company's share of the net investment income for the taxable year, by

"(B) the net investment income for the taxable year.

"(2) POLICYHOLDERS' SHARE.—For purposes of section 807, the term 'policyholders' share' means, with respect to any taxable year, the excess of 100 percent over the percentage determined under paragraph (1).

"(b) COMPANY'S SHARE OF NET INVESTMENT INCOME.—For purposes of this section, the company's share of net investment income is the excess (if any) of—

"(1) the net investment income for the taxable year, over

"(2) the sum of—

"(A) the deduction for policyholders' dividends determined under sections 808 and 809 for the taxable year, and

"(B) all amounts in the nature of interest paid or credited to customers pursuant to insurance or annuity contracts.

For purposes of paragraph (2)(B), the term 'insurance or annuity contract' shall include any pension plan contract.

"(c) NET INVESTMENT INCOME.—For purposes of this section, the term 'net investment income' means the excess of—

"(1) gross investment income, over

"(2) investment expenses.

"(d) GROSS INVESTMENT INCOME.—For purposes of this section, the term 'gross investment income' means the sum of the following:

"(1) INTEREST, ETC.—The gross amount of income from—

"(A) interest (including tax-exempt interest), dividends, rents, and royalties,

"(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interest, rents, or royalties, and

"(C) the alteration or termination of any instrument or agreement described in subparagraph (B).

"(2) SHORT-TERM CAPITAL GAIN.—The amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

"(3) TRADE OR BUSINESS INCOME.—The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

Except as provided in paragraph (2), in computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

"(e) INVESTMENT EXPENSES.—For purposes of this section, the term 'investment expenses' means the sum of—

"(1) the deductions allowable which are directly connected with the production of investment income (other than the deductions under sections 243, 244, and 245), and

"(2) an amount equal to the general expenses of the life insurance company for the taxable year multiplied by a fraction—

"(A) the numerator of which is the gross investment income for the taxable year, and

"(B) the denominator of which is the gross receipts of the life insurance company for the taxable year.

"(f) DIVIDENDS FROM CERTAIN SUBSIDIARIES NOT INCLUDED IN GROSS INVESTMENT INCOME.—For purposes of this section, the term 'gross investment income' shall not include any dividend received by the life insurance company which is a 100-percent dividend (as defined in section 805(a)(4)(C)). Such term also shall not include any dividend described in section 804(a)(4)(D) (relating to certain dividends in the case of foreign corporations).

"(g) NO DOUBLE COUNTING.—Under regulations, proper adjustments shall be made in the application of this section to prevent an item from being counted more than once.

"SEC. 813. FOREIGN LIFE INSURANCE COMPANIES.

"(a) ADJUSTMENT WHERE SURPLUS HELD IN THE UNITED STATES IS LESS THAN SPECIFIED MINIMUM.—

"(1) IN GENERAL.—In the case of any foreign company taxable under this part, if—

"(A) the required surplus determined under paragraph (2), exceeds

"(B) the surplus held in the United States, then its income effectively connected with the conduct of an insurance business within the United States shall be increased by an amount determined by multiplying such excess by such company's current investment yield.

"(2) REQUIRED SURPLUS.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'required surplus' means the amount determined by multiplying the taxpayer's total insurance liabilities on United States business by a percentage for the taxable year determined and proclaimed by the Secretary under subparagraph (B).

"(B) DETERMINATION OF PERCENTAGE.—The percentage determined and proclaimed by the Secretary under this subparagraph shall be based on such data with respect to domestic life insurance companies for the preceding taxable year as the Secretary considers representative. Such percentage shall be computed on the basis of a ratio the numerator of which is the excess of the assets over the total insurance liabilities, and the denominator of which is the total insurance liabilities.

"(3) CURRENT INVESTMENT YIELD.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'current investment yield' means the percent obtained by dividing—

"(i) the net investment income on assets held in the United States, by

"(ii) the mean of the assets held in the United States during the taxable year.

"(B) DETERMINATIONS BASED ON AMOUNT SET FORTH IN THE ANNUAL STATEMENT.—Except as otherwise provided in regulations, determinations under subparagraph (A) shall be made on the basis of the amounts required to be set forth on the annual statement approved by the National Association of Insurance Commissioners.

"(4) OTHER DEFINITIONS.—For purposes of this subsection—

"(A) SURPLUS HELD IN THE UNITED STATES.—The surplus held in the United States is the excess of the assets (determined under section 806(b)(3)(C)) held in the United States over the total insurance liabilities on United States business.

"(B) TOTAL INSURANCE LIABILITIES.—For purposes of this subsection, the term 'total insurance liabilities' means the sum of the total reserves (as defined in section 816(c)) plus (to the extent not included in total reserves) the items referred to in paragraphs (3), (4), (5), and (6) of section 807(c).

"(5) REDUCTION OF SECTION 881 TAXES.—In the case of any foreign company taxable under this part, there shall be determined—

"(A) the amount which would be subject to taxes under section 881 if the amount taxable under such section were determined without regard to sections 103 and 894, and

"(B) the amount of the increase provided by paragraph (1).

The tax under section 881 (determined without regard to this paragraph) shall be reduced (but not below zero) by an amount which is the same proportion of such tax as the amount referred to in subparagraph (B) is of the amount referred to in subparagraph (A); but such reduction in taxes shall not exceed the increase in taxes under this part by reason of the increase provided by paragraph (1).

"(b) ADJUSTMENT TO LIMITATION ON DEDUCTION FOR POLICYHOLDER DIVIDENDS IN THE CASE OF FOREIGN MUTUAL LIFE INSURANCE COMPANIES.—For purposes of section 809, the equity base of any foreign mutual life insurance company as of the close of any taxable year shall be increased by the amount of any excess determined under paragraph (1) of subsection (a) with respect to such taxable year.

"(c) CROSS REFERENCE.—

"For taxation of foreign corporations carrying on life insurance business within the United States, see section 842.

"SEC. 814. CONTIGUOUS COUNTRY BRANCHES OF DOMESTIC LIFE INSURANCE COMPANIES.

"(a) EXCLUSION OF ITEMS.—In the case of a domestic mutual insurance company which—

"(1) is a life insurance company,

"(2) has a contiguous country life insurance branch, and

"(3) makes the election provided by subsection (g) with respect to such branch,

there shall be excluded from each item involved in the determination of life insurance company taxable income the items separately accounted for in accordance with subsection (c).

"(b) CONTIGUOUS COUNTRY LIFE INSURANCE BRANCH.—For purposes of this section, the term contiguous country life insurance branch means a branch which—

"(1) issues insurance contracts insuring risks in connection with the lives or health of residents of a country which is contiguous to the United States,

"(2) has its principal place of business in such contiguous country, and

"(3) would constitute a mutual life insurance company if such branch were a separate domestic insurance company.

For purposes of this section, the term 'insurance contract' means any life, health, accident, or annuity contract or reinsurance contract or any contract relating thereto.

"(c) SEPARATE ACCOUNTING REQUIRED.—Any taxpayer which makes the election provided by subsection (g) shall establish and maintain a separate account for the various income, exclusion, deduction, asset, reserve, liability, and surplus items properly attributable to the contracts described in subsection (b). Such separate accounting shall be made—

"(1) in accordance with the method regularly employed by such company, if such method clearly reflects income derived from, and the other items attributable to, the contracts described in subsection (b), and

"(2) in all other cases, in accordance with regulations prescribed by the Secretary.

"(d) RECOGNITION OF GAIN ON ASSETS IN BRANCH ACCOUNT.—If the aggregate fair market value of all the invested assets and tangible property which are separately accounted for by the domestic life insurance company in the branch account established pursuant to subsection (c) exceeds the aggregate adjusted basis of such assets for purposes of determining gain, then the domestic life insurance company shall be treated as having sold all such assets on the first day of the first taxable year for which the election is in effect at their fair market value on such first day. Notwithstanding any other provision of this chapter, the net gain shall be recognized to the domestic life insurance company on the deemed sale described in the preceding sentence.

"(e) TRANSACTIONS BETWEEN CONTIGUOUS COUNTRY BRANCH AND DOMESTIC LIFE INSURANCE COMPANY.—

"(1) REIMBURSEMENT FOR HOME OFFICE SERVICES, ETC.—Any payment, transfer, reimbursement, credit, or allowance which is made from a separate account established pursuant to subsection (c) to one or more other accounts of a domestic life insurance company as reimbursement for costs incurred for or with respect to the insurance (or reinsurance) of risks accounted for in such separate account shall be taken into account by the domestic life insurance company in the same manner as if such payment, transfer, reimbursement, credit, or allowance had been received from a separate person.

"(2) REPATRIATION OF INCOME.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), any amount directly or indirectly transferred or credited from a branch account established pursuant to subsection (c) to one or more other accounts of such company shall, unless such transfer or credit is a reimbursement to which paragraph (1) applies, be added to the income of the domestic life insurance company.

"(B) LIMITATION.—The addition provided by subparagraph (A) for the taxable year with respect to any contiguous country life insurance branch shall not exceed the amount by which—

"(i) the aggregate decrease in the tentative LICTI of the domestic life insurance company for the taxable year and for all prior taxable years resulting solely from the application of subsection (a) of this section with respect to such branch, exceeds "(ii) the amount of additions to tentative LICTI pursuant to subparagraph (A) with respect to such contiguous country branch for all prior taxable years.

"(C) TRANSITIONAL RULE.—For purposes of this paragraph, in the case of a prior taxable year beginning before January 1, 1984, the term 'tentative LICTI' means life insurance company taxable income determined under this part (as in effect for such year) without regard to this paragraph.

"(f) OTHER RULES.—

"(1) TREATMENT OF FOREIGN TAXES.—

"(A) IN GENERAL.—No income, war profits, or excess profits taxes paid or accrued to any foreign country or possession of the United States which is attributable to income excluded under subsection (a) shall be taken into account for purposes of subpart A of part III of subchapter N (relating to foreign tax credit) or allowable as a deduction.

"(B) TREATMENT OF REPATRIATED AMOUNTS.—For purposes of sections 78 and 902, where any amount is added to the life insurance company taxable income of the domestic life insurance company by reason of subsection (e)(2), the contiguous country life insurance branch shall be treated as a foreign corporation. Any amount so added shall be treated as a dividend paid by a foreign corporation, and the taxes paid to any foreign country or possession of the United States with respect to such amount shall be deemed to have been paid by such branch.

"(2) UNITED STATES SOURCE INCOME ALLOCABLE TO CONTIGUOUS COUNTRY BRANCH.—For purposes of sections 881, 882, and 1442, each contiguous country life insurance branch shall be treated as a foreign corporation. Such sections shall be applied to each such branch in the same manner as if such sections contained the provisions of any treaty to which the United States and the contiguous country are parties, to the same extent such provisions would apply if such branch were incorporated in such contiguous country.

"(g) ELECTION.—A taxpayer may make the election provided by this subsection with respect to any contiguous country for any taxable year. An election made under this subsection for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary. The election provided by this subsection shall be made not later than the time prescribed by law for filing the return for the taxable year (including extensions thereof) with respect to which such election is made, and such election and any approved revocation thereof shall be made in the manner provided by the Secretary.

"(h) SPECIAL RULE FOR DOMESTIC STOCK LIFE INSURANCE COMPANIES.—At the election of a domestic stock life insurance company which has a contiguous country life insurance branch described in subsection (b) (without regard to the mutual requirement in subsection (b)(3)), the assets of such branch may be transferred to a foreign corporation organized under the laws of the contiguous country without the application of section 367 or 1491. Subsection (a) shall apply to the stock of such foreign corporation as if such domestic company were a mutual company and as if the stock were an item described in subsection (c). Subsection (e)(2) shall apply to amounts transferred or credited to such domestic company as if such domestic company and such foreign corporation constituted one domestic mutual life insurance company. The insurance contracts which may be transferred pursuant to this subsection shall include only those which are similar to the types of insurance contracts issued by a mutual life insurance company. Notwithstanding the first sentence of this subsection, if the aggregate fair market value of the invested assets and tangible property which are separately accounted for by the domestic life insurance company in the branch account exceeds the aggregate adjusted basis of such assets for purposes of determining gain, the domestic life insurance company shall be deemed to have sold all such assets on the first day of the taxable year for which the election under this subsection applies and the net gain shall be recognized to the domestic life insurance company on the deemed sale, but not in excess of the proportion of such net gain which equals the proportion which the aggregate fair market value of such assets which are transferred pursuant to this subsection is of the aggregate fair market value of all such assets.

"SEC. 815. DISTRIBUTIONS TO SHAREHOLDERS FROM PRE-1984 POLICYHOLDERS SURPLUS ACCOUNT.

"(a) GENERAL RULE.—The life insurance company taxable income (within the meaning of section 801(b)) for any taxable year of any stock life insurance company which has an existing policyholders surplus account shall be increased by any direct or indirect distribution to shareholders from such account. For purposes of the preceding sentence, the life insurance company taxable income (within the meaning of section 801(b)) shall be treated as not less than zero.

"(b) ORDERING RULE.—For purposes of this section, any distribution to shareholders shall be treated as made—

"(1) first out of the shareholders surplus account, to the extent thereof, "(2) then out of the policyholders surplus account, to the extent thereof, and

"(3) finally, out of other accounts.

"(c) SHAREHOLDERS SURPLUS ACCOUNT.—

"(1) IN GENERAL.—Each stock life insurance company which has an existing policyholders surplus account shall continue its shareholders surplus account for purposes of this part.

"(2) ADDITIONS TO ACCOUNT.—The amount added to the shareholders surplus account for any taxable year beginning after December 31, 1983, shall be the excess of—

"(A) the sum of—

"(i) the life insurance company's taxable income (determined without regard to this section),

"(ii) the special deductions provided by section 806, and

"(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 805(a)(4)) and the amount of interest excluded from gross income under section 103, over

"(B) the taxes imposed for the taxable year by section 801 (determined without regard to this section).

"(3) SUBTRACTIONS FROM ACCOUNT.—There shall be subtracted from the shareholders surplus account for any taxable year the amount which is treated under this section as distributed out of such account.

"(d) POLICYHOLDERS SURPLUS ACCOUNT.—

"(1) IN GENERAL.—Each stock life insurance company which has an existing policholders surplus account shall continue such account.

"(2) NO ADDITIONS TO ACCOUNT.—No amount shall be added to the policyholders surplus account for any taxable year beginning after December 31, 1983.

"(3) SUBTRACTIONS FROM ACCOUNT.—There shall be subtracted from the policyholders surplus account for any taxable year an amount equal to the sum of—

"(A) the amount which (without regard to subparagraph (B)) is treated under this section as distributed out of the policyholders surplus account, and

"(B) the amount by which the tax imposed for the taxable year by section 801 is increased by reason of this section.

"(e) EXISTING POLICYHOLDERS SURPLUS ACCOUNT.—For purposes of this section, the term 'existing policyholders surplus account' means any policyholders surplus account which has a balance as of the close of December 31, 1983.

"(f) OTHER RULES APPLICABLE TO POLICYHOLDERS SURPLUS ACCOUNT CONTINUED.—Except to the extent inconsistent with the provisions of this part, the provisions of subsections (d), (e), (f), and (g) of section 815 (and of sections 6501(c)(6), 6501(k), 6511(d)(6), 6601(d)(3), and 6611(f)(4)) as in effect before the enactment of the Life Insurance Tax Act of 1984 are hereby made applicable in respect of any policyholders surplus account for which there was a balance as of December 31, 1983.

"Subpart E—Definitions and Special Rules

"Sec. 816. Life insurance company defined.
"Sec. 817. Treatment of variable contracts.
"Sec. 818. Other definitions and special rules.

"SEC. 816. LIFE INSURANCE COMPANY DEFINED.

"(a) LIFE INSURANCE COMPANY DEFINED.—For purposes of this subtitle, the term 'life insurance company' means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with accident and health insurance), or noncancellable contracts of health and accident insurance, if—

"(1) its life insurance reserves (as defined in subsection (b)), plus

"(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, accident, or health policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)). For purposes of the preceding sentence, the term 'insurance company' means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

"(b) LIFE INSURANCE RESERVES DEFINED.—

"(1) IN GENERAL.—For purposes of this part, the term 'life insurance reserves' means amounts—

"(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

"(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts (including life insurance or annuity contracts combined with noncancellable accident and health insurance) involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies.

"(2) RESERVES MUST BE REQUIRED BY LAW.—Except—

"(A) in the case of policies covering life, accident, and health insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, and

"(B) as provided in paragraph (3),

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

"(3) ASSESSMENT COMPANIES.—In the case of an assessment life insurance company or association, the term 'life insurance reserves' includes—

"(A) sums actually deposited by such company or association with State officers pursuant to law as guaranty or reserve funds, and

"(B) any funds maintained, under the charter or articles of incorporation or association (or bylaws approved by a State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued on the assessment plan and not subject to any other use.

"(4) DEFICIENCY RESERVES EXCLUDED.—

"(A) IN GENERAL.—The term 'life insurance reserves' does not include deficiency reserves.

"(B) DEFICIENCY RESERVE DEFINED.—For purposes of this subsection and subsection (c), the deficiency reserve for any contract is that portion of the reserve for such contract equal to the amount (if any) by which—

"(i) the present value of the future net premiums required for such contract, exceeds

"(ii) the present value of the future actual premiums and consideration charged for such contract.

"(5) AMOUNT OF RESERVES.—For purposes of this subsection, subsection (a), and subsection (c), the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

"(c) TOTAL RESERVES DEFINED.—For purposes of subsection (a), the term 'total reserves' means—

"(1) life insurance reserves,

"(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

"(3) all other insurance reserves required by law.

The term 'total reserves' does not include deficiency reserves (within the meaning of subsection (b)(4)).

"(d) ADJUSTMENTS IN RESERVES FOR POLICY LOANS.—For purposes only of determining under subsection (a) whether or not an insurance company is a life insurance company, the life insurance reserves, and the total reserves, shall each be reduced by an amount equal to the mean of the aggregates, at the beginning and end of the taxable year, of the policy loans outstanding with respect to contracts for which life insurance reserves are maintained.

"(e) GUARANTEED RENEWABLE CONTRACTS.—For purposes of this part, guaranteed renewable life, accident, and health insurance shall be treated in the same manner as noncancellable life, accident, and health insurance.

"(f) AMOUNTS NOT INVOLVING LIFE, ACCIDENT, OR HEALTH CONTINGENCIES.—For purposes only of determining under subsection (a) whether or not an insurance company is a life insurance company, amounts set aside and held at interest to satisfy obligations under contracts which do not contain permanent guarantees with respect to life, accident, or health contingencies shall not be included in life insurance reserves or in total reserves.

"(g) BURIAL AND FUNERAL BENEFIT INSURANCE COMPANIES.—A burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under this part but shall be taxable under section 821 or section 831.

"SEC. 817. TREATMENT OF VARIABLE CONTRACTS.

"(a) INCREASES AND DECREASES IN RESERVES.—For purposes of subsections (a) and (b) of section 807, the sum of the items described in section 807(c) taken into account as of the close of the taxable year with respect to any variable contract shall, under regulations prescribed by the Secretary, be adjusted—

"(1) by subtracting therefrom an amount equal to the sum of the amounts added from time to time (for the taxable year) to the reserves separately accounted for in accordance with subsection (b) by reason of appreciation in value of assets (whether or not the assets have been disposed of), and

"(2) by adding thereto an amount equal to the sum of the amounts subtracted from time to time (for the taxable year) from such reserves by reason of depreciation in value of assets (whether or not the assets have been disposed of).

The deduction allowable for items described in paragraphs (1) and (6) of section 805(a) with respect to variable contracts shall be reduced to the extent that the amount of such items is increased for the taxable year by appreciation (or increased to the extent that the amount of such items is decreased for the taxable year by depreciation) not reflected in adjustments under the preceding sentence.

"(b) SEPARATE ACCOUNTING.—For purposes of this part (other than section 809), a life insurance company which issues variable contracts shall separately account for the various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to such variable contracts. For such items as are not accounted for directly, separate accounting shall be made—

"(1) in accordance with the method regularly employed by such company, if such method is reasonable, and

"(2) in all other cases, in accordance with regulations prescribed by the Secretary.

"(c) VARIABLE CONTRACT DEFINED.—For purposes of this part, the term 'variable contract' means a contract—

"(1) which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company,

"(2) which—

"(A) provides for the payment of annuities, or

"(B) is a life insurance contract, and

"(3) under which—

"(A) in the case of an annuity contract, the amounts paid in, or the amount paid out, reflect the investment return and the market value of the segregated asset account, or

"(B) in the case of a life insurance contract, the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account.

If a contract ceases to reflect current investment return and current market value, such contract shall not be considered as meeting the requirements of paragraph (3) after such cessation.

"(d) SPECIAL RULES FOR PENSION PLAN CONTRACTS.—

"(1) TREATMENT AS PAYING ANNUITY.—A pension plan contract which is not a life, accident, or health, property, casualty, or liability insurance contract shall be treated as a contract which provides for the payment of annuities for purposes of subsection (c).

"(2) BASIS OF ASSETS HELD FOR PENSION PLAN CONTRACT.—In the case of pension plan contracts which are variable contracts, the basis of each asset in a segregated asset account shall (in addition to all other adjustments to basis) be—

"(A) increased by the amount of any appreciation in value, and

"(B) decreased by the amount of any depreciation in value,

to the extent that such appreciation and depreciation are from time to time reflected in the increases and decreases in reserves or other items referred to in subsection (a) with respect to such contracts.

"(e) OTHER SPECIAL RULES.—

"(1) LIFE INSURANCE RESERVES.—For purposes of subsection (b)(1)(A) of section 816, the reflection of the investment return and the market value of the segregated asset account shall be considered an assumed rate of interest.

"(2) ADDITIONAL SEPARATE COMPUTATIONS.—Under regulations prescribed by the Secretary, such additional separate computations shall be made, with respect to the items separately accounted for in accordance with subsection (b), as may be necessary to carry out the purposes of this section and this part.

"(f) VARIABLE ANNUITY CONTRACTS TREATED AS ANNUITY CONTRACTS.—For purposes of this part, the term 'annuity contract' includes a contract which provides for the payment of a variable annuity computed on the basis of—

"(1) recognized mortality tables, and

"(2)(A) the investment experience of a segregated asset account, or

"(B) the company-wide investment experience of the company.

Paragraph (2)(B) shall not apply to any company which issues contracts which are not variable contracts.

"SEC. 818. OTHER DEFINITIONS AND SPECIAL RULES.

"(a) PENSION PLAN CONTRACTS.—For purposes of this part, the term 'pension plan contract' means any contract—

"(1) entered into with trusts which (as of the time the contracts were entered into) were deemed to be trusts described in section 401(a) and exempt from tax under section 501(a), (or trusts exempt from tax under section 165 of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws);

"(2) entered into under plans which (as of the time the contracts were entered into) were deemed to be plans described in section 403(a), or plans meeting the requirements of paragraphs (3), (4), (5), and (6) of section 165(a) of the Internal Revenue Code of 1939;

"(3) provided for employees of the life insurance company under a plan which, for the taxable year, meets the requirements of paragraphs (3), (4), (5), (6), (7), (8), (11), (12), (13), (14), (15), (16), (19), (20), and (22) of section 401(a);

"(4) purchased to provide retirement annuities for its employees by an organization which (as of the time the contracts were purchased) was an organization described in section 501(c)(3) which was exempt from tax under section 501(a) (or was an organization exempt from tax under section 101(6) of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws), or purchased to provide retirement annuities for employees described in section 403(b)(1)(A)(ii) by an employer which is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing;

"(5) entered into with trusts which (at the time the contracts were entered into) were individual retirement accounts described in section 408(a) or under contracts entered into with individual retirement annuities described in section 408(b); or

"(6) purchased by—

"(A) a governmental plan (within the meaning of section 414(d)), or

"(B) the Government of the United States, the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing, for use in satisfying an obligation of such government, political subdivision, or agency or instrumentality to provide a benefit under a plan described in subparagraph (A).

"(b) TREATMENT OF CAPITAL GAINS AND LOSSES, ETC.—In the case of a life insurance company—

"(1) in applying section 1231(a), the term 'property used in the trade or business' shall be treated as including only—

"(A) property used in carrying on an insurance business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in carrying on an insurance business, held for more than 1 year, which is not described in section 1231(b)(1)(A), (B), or (C), and

"(B) property described in section 1231(b)(2), and

"(2) in applying section 1221(2), the reference to property used in trade or business shall be treated as including only property used in carrying on an insurance business.

"(c) GAIN ON PROPERTY HELD ON DECEMBER 31, 1958 AND CERTAIN SUBSTITUTED PROPERTY ACQUIRED AFTER 1958.—

"(1) PROPERTY HELD ON DECEMBER 31, 1958.—In the case of property held by the taxpayer on December 31, 1958, if—

"(A) the fair market value of such property on such date exceeds the adjusted basis for determining gain as of such date, and

"(B) the taxpayer has been a life insurance company at all times on and after December 31, 1958,

the gain on the sale or other disposition of such property shall be treated as an amount (not less than zero) equal to the amount by which the gain (determined without regard to this subsection) exceeds the difference between the fair market value on December 31, 1958, and the adjusted basis for determining gain as of such date.

"(2) CERTAIN PROPERTY ACQUIRED AFTER DECEMBER 31, 1958.—In the case of property acquired after December 31, 1958, and having a substituted basis (within the meaning of section 1016(b))—

"(A) for purposes of paragraph (1), such property shall be deemed held continuously by the taxpayer since the beginning of the holding period thereof, determined with reference to section 1223,

"(B) the fair market value and adjusted basis referred to in paragraph (1) shall be that of that property for which the holding period taken into account includes December 31, 1958,

"(C) paragraph (1) shall apply only if the property or properties the holding periods of which are taken into account were held only by life insurance companies after December 31, 1958, during the holding periods so taken into account,

"(D) the difference between the fair market value and adjusted basis referred to in paragraph (1) shall be reduced (to not less than zero) by the excess of (i) the gain that would have been recognized but for this subsection on all prior sales or dispositions after December 31, 1958, of properties referred to in subparagraph (C), over (ii) the gain which was recognized on such sales or other dispositions, and

"(E) the basis of such property shall be determined as if the gain which would have been recognized but for this subsection were recognized gain.

"(3) PROPERTY DEFINED.—For purposes of paragraphs (1) and (2), the term 'property' does not include insurance and annuity contracts and property described in paragraph (1) of section 1221.

"(d) INSURANCE OR ANNUITY CONTRACT INCLUDES CONTRACTS SUPPLEMENTARY THERETO.—For purposes of this part, the term 'insurance or annuity contract' includes any contract supplementary thereto.

"(e) SPECIAL RULE FOR CONSOLIDATED RETURNS.—If an election under section 1504(c)(2) is in effect with respect to an affiliated group for the taxable year, all items of the members of such group which are not life insurance companies shall not be taken into account in determining the amount of the tentative LICTI of members of such group which are life insurance companies.

"(f) ALLOCATION OF CERTAIN ITEMS FOR PURPOSES OF FOREIGN TAX CREDIT, ETC.—

"(1) IN GENERAL.—Under regulations, in applying sections 861, 862, and 863 to a life insurance company, the deduction for policyholder dividends (determined under section 808(c)), reserve adjustments under subsections (a) and (b) of section 807, and death benefits and other amounts described in section 805(a)(1) shall be treated as items which cannot definitely be allocated to an item or class of gross income.

"(2) ELECTION OF ALTERNATIVE ALLOCATION.—

"(A) IN GENERAL.—On or before September 15, 1984, any life insurance company may elect to treat items described in paragraph (1) as properly apportioned or allocated among items of gross income to the extent (and in the manner) prescribed in regulations.

"(B) ELECTION IRREVOCABLE.—Any election under subparagraph (A), once made, may be revoked only with the consent of the Secretary."

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Subclause (IV) of section 72(e)(5)(D)(i) is amended by striking out "section 805(d)(3)" and inserting in lieu thereof "section 818(a)(3)".

(2) Subsection (a) of section 80 (relating to restoration of value of certain securities) is amended by striking out "802" and inserting in lieu thereof "801".

(3)(A) Subparagraph (C) of section 243(b)(3) (relating to effect of election) is amended by striking out clause (iii), by adding "and" at the end of clause (ii), and by redesignating clause (iv) as clause (iii).

(B) Paragraph (6) of section 243(b) (relating to special rules for insurance companies) is amended by striking out "section 802" and inserting in lieu thereof "section 801".

(4) Subsection (d) of section 381 (relating to carryover in certain corporate acquisitions) is amended by striking out "section 812(f)" and inserting in lieu thereof "section 810".

(5) Paragraph (24) of section 401(a) (relating to qualified pension, profit-sharing, and stock bonus plans) is amended by striking out "section 805(d)(6)" and inserting in lieu thereof "section 818(a)(6)".

(6)(A) Paragraph (1) of section 453B(e) (relating to life insurance companies) is amended by striking out "section 801(a)" and inserting in lieu thereof "section 816(a)".

(B) Paragraph (2) of section 453B(e) is amended to read as follows:

"(2) SPECIAL RULE WHERE LIFE INSURANCE COMPANY ELECTS TO TREAT INCOME AS NOT RELATED TO INSURANCE BUSINESS.—Paragraph (1) shall not apply to any transfer or deemed transfer of an installment obligation if the life insurance company elects (at such time and in such manner as the Secretary may by regulations prescribe) to determine its life insurance company taxable income—

"(A) by returning the income on such installment obligation under the installment method prescribed in section 453, and

"(B) as if such income were an item attributable to a noninsurance business (as defined in section 806(c)(3))."

(7) Paragraph (5) of section 542(b) (relating to certain dividend income received from a nonincludible life insurance company) is amended by striking out "section 802" and inserting in lieu thereof "section 801".

(8) Subsection (b) of section 594 (relating to alternative tax for mutual savings banks conducting life insurance business) is amended by striking out "section 801" and inserting in lieu thereof "section 816".

(9) Paragraph (4) of section 832(b) (defining premiums earned) is amended by striking out "section 801(b)" and inserting in lieu thereof "section 816(b) but determined as provided in section 807" and by striking out "section 801" and inserting in lieu thereof "section 816".

(10) Section 841 (relating to credit for foreign taxes) is amended—

(A) by striking out "section 802," each place it appears and inserting in lieu thereof "section 801,", and

(B) by striking out "section 802(b)" and inserting in lieu thereof "section 801(b)".

(11)(A) Subsection (a) of section 844 (relating to special loss carryover rules) is amended—

(i) by striking out "section 812," and inserting in lieu thereof "section 810 (or the corresponding provisions of prior law),", and

(ii) by striking out "section 812(a)" and inserting in lieu thereof "section 810(a)".

(B) Subsection (b) of section 844 is amended—

(i) by striking out "section 812(a)" and inserting in lieu thereof "section 810(a)", and

(ii) by striking out "section 812(b)(1)(C)" in paragraph (2) and inserting in lieu thereof "section 810(b)(1)(C)".

(12) Section 891 (relating to doubling of rates of tax on citizens and corporations of certain foreign countries) is amended by striking out "802" and inserting in lieu thereof "801".

(13)(A) Subsection (b) of section 953 (relating to income from insurance of United States risks) is amended by striking out paragraph (1) and by redesignating paragraphs (2), (3), (4), and (5) as paragraphs (1), (2), (3), and (4), respectively.

(B) Paragraph (2) of section 953(b), as redesignated by subparagraph (A), is amended to read as follows:

"(2) The following provisions of subchapter L shall not apply:

"(A) The special life insurance company deduction and the small life insurance company deduction.

"(B) Section 805(a)(5) (relating to operations loss deduction).

"(C) Section 832(c)(5) (relating to certain capital losses)."

(C) Paragraph (3) of section 953(b), as redesignated by subparagraph (A), is amended by—

(i) striking out "section 809(c)(1)" and inserting in lieu thereof "section 803(a)(1)", and

(ii) by striking out "section 809(c)(2)" and inserting in lieu thereof "section 803(a)(2)", and

(iii) by striking out "section 809(d)(2)" and inserting in lieu thereof "section 805(a)(2)".

(D) Paragraph (2) of section 953(a) is amended by striking out ", (2), and (3)" and inserting in lieu thereof "and (2)".

(E) Paragraph (4) of section 953(b), as redesignated by subparagraph (A), is amended by striking out "paragraph (4)" and inserting in lieu thereof "paragraph (3)".

(14) Paragraph (17) of section 1016(a) is amended by striking out "section 818(b)" each place it appears and inserting in lieu thereof "section 811(b)".

(15) Paragraph (1) of section 1035(b) (defining endowment contract) is amended by striking out "section 801" and inserting in lieu thereof "section 816".

(16) Paragraph (1) of section 1201(b) (relating to cross references) is amended by striking out "section 802(a)(2)" and inserting in lieu thereof "section 801(a)(2)".

(17) Subparagraph (B) of section 1232A(c)(4) (relating to original issue discount) is amended by striking out "section 818(b)" and inserting in lieu thereof "section 811(b)".

(18)(A) Paragraph (1) of section 1351(a) (relating to treatment of recoveries of foreign expropriation losses) is amended by striking out "802" each place it appears and inserting in lieu thereof "801".

(B) Paragraph (2) of section 1351(c) (relating to amount of recovery) is amended by striking out "section 810(c)" and inserting in lieu thereof "section 807(c)".

(C) Paragraph (3) of section 1351(i) (relating to adjustments for succeeding years) is amended by striking out "section 812" and inserting in lieu thereof "section 810".

(19)(A) Subsection (c) of section 1503 (relating to special rules for application of certain losses against income of insurance companies taxed under section 802) is amended by striking out "section 802" each place it appears and inserting in lieu thereof "section 801".

(B) Paragraph (1) of section 1503(c) is amended by striking out the third sentence.

(C) The subsection heading of section 1503(c) is amended by striking out "SECTION 802" and inserting in lieu thereof "SECTION 801".

(20) Subsections (b)(2), (c)(1), and (c)(2)(A) of section 1504 (defining affiliated group) are each amended by striking out "section 802" and inserting in lieu thereof "section 801".

(21)(A) Subsection (a) of section 1561 (relating to limitations on certain multiple tax benefits in the case of certain controlled corporations) is amended—

(i) by striking out paragraphs (3) and (4), by adding "and" at the end of paragraph (1), and by striking out the comma at the end of paragraph (2) and inserting in lieu thereof a period, and

(ii) by striking out "paragraphs (2), (3), and (4)" in the last sentence and inserting in lieu thereof "paragraph (2)".

(B) Subsection (b) of section 1561 is amended—

(i) by striking out paragraphs (3) and (4) and by adding "and" at the end of paragraph (1), and

(ii) by striking out ", (2), (3), or (4)" and inserting in lieu thereof "or (2)".

(22) Subsections (a)(4) and (b)(2)(D) of section 1563 (defining controlled group of corporations) are each amended by striking out "section 802" and inserting in lieu thereof "section 801".

(23) Paragraph (2) of section 4371 (relating to imposition of tax on policies issued by foreign insurers) is amended by striking out "section 819" and inserting in lieu thereof "section 813".

(24)(A) Subsection (c) of section 6501 (relating to limitations on assessment and collection) is amended by striking out paragraph (6) and by redesignating paragraph (7) as paragraph (6).

(B) Subsection (k) of section 6501 (relating to reductions of policyholders surplus account of life insurance companies) is hereby repealed.

(25) Subsection (d) of section 6511 (relating to limitations on credit or refund) is amended by striking out paragraph (6) and by redesignating paragraph (7) as paragraph (6).

(26) Subsection (d) of section 6601 (relating to interest on underpayments, etc.) is amended by striking out paragraph (3) and by redesignating paragraph (4) as paragraph (3).

(27) Subsection (f) of section 6611 (relating to interest on overpayments) is amended by striking out paragraph (4).

PART II—EFFECTIVE DATE; TRANSITIONAL RULES

Subpart A—Effective Date

SEC. 215. EFFECTIVE DATE.

The amendments made by this subtitle shall apply to taxable years beginning after December 31, 1983.

Subpart B—Transitional Rules

SEC. 216. RESERVES COMPUTED ON NEW BASIS; FRESH START.

(a) IN GENERAL.—As of the beginning of the first taxable year beginning after December 31, 1983, for purposes of part I of subchapter L of the Internal Revenue Code of 1954 (other than section 816 thereof), the reserve for any contract shall be recomputed as if the amendments made by this subtitle had applied to such contract when it was issued.

(b) FRESH START.—

(1) IN GENERAL.—Except as provided in paragraph (2), in the case of any life insurance company, any change in the method of accounting (and any change in the method of computing reserves) between such company's first taxable year beginning after December 31, 1983, and the preceding taxable year which is required solely by the amendments made by this subtitle shall be treated as not being a change in the method of accounting (or change in the method of computing reserves) for purposes of the Internal Revenue Code of 1954.

(2) TREATMENT OF ADJUSTMENTS FROM YEARS BEFORE 1984.—

(A) ADJUSTMENTS ATTRIBUTABLE TO DECREASES IN RESERVES.—No adjustment under section 810(d) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) attributable to any decrease in reserves as a result of a change in a taxable year beginning before 1984 shall be taken into account in any taxable year beginning after 1983.

(B) ADJUSTMENTS ATTRIBUTABLE TO INCREASES IN RESERVES.—

(i) IN GENERAL.—Any adjustment under section 810(d) of the Internal Revenue Code of 1954 (as so in effect) attributable to an increase in reserves as a result of a change in a taxable year beginning before 1984 shall be taken into account in taxable years beginning after 1983 to the extent that—

(I) the amount of the adjustments which would be taken into account under such section in taxable years beginning after 1983 without regard to this subparagraph, exceeds

(II) the amount of any fresh start adjustment attributable to contracts for which there was such an increase in reserves as a result of such change.

(ii) FRESH START ADJUSTMENT.—For purposes of clause (i), the fresh start adjustment with respect to any contract is the excess (if any) of—

(I) the reserve attributable to such contract as of the close of the taxpayer's last taxable year beginning before January 1, 1984, over

(II) the reserve for such contract as of the beginning of the taxpayer's first taxable year beginning after 1983 as recomputed under subsection (a) of this section.

(C) RELATED INCOME INCLUSIONS NOT TAKEN INTO ACCOUNT TO THE EXTENT DEDUCTION DISALLOWED UNDER SUBPARAGRAPH (B).—No premium shall be included in income to the extent such premium is directly related to an increase in a reserve for which a deduction is disallowed by subparagraph (B).

(3) REINSURANCE TRANSACTIONS, AND RESERVE STRENGTHENING, AFTER SEPTEMBER 27, 1983.—Paragraph (1) shall not apply (and section 807(f) of the Internal Revenue Code of 1954 as amended by this subtitle shall apply) to any reserve transferred (or expenses transferred) pursuant to a reinsurance agreement entered into, modified, or terminated after September 27, 1983, and before January 1, 1984 (or to any reserve strengthening reported for Federal income

tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984). Any amount included in income under section 807(f) of such Code by reason of the preceding sentence (and any income attributable to transferred expenses described in the preceding sentence) shall not be taken into account for purposes of determining the amount of the special life insurance company deduction and the small life insurance company deduction.

SEC. 217. OTHER SPECIAL RULES.

(a) NEW SECTION 814 TREATED AS CONTINUATION OF SECTION 819A.—For purposes of section 814 of the Internal Revenue Code of 1954 (relating to contiguous country branches of domestic life insurance companies)—

(1) any election under section 819A of such Code (as in effect on the day before the date of the enactment of this Act) shall be treated as an election under such section 814, and

(2) any reference to a provision of such section 814 shall be treated as including a reference to the corresponding provision of such section 819A.

(b) TREATMENT OF ELECTIONS UNDER SECTION 453B(e)(2).—If an election is made under section 453B(e)(2) before January 1, 1984, with respect to any installment obligation, any income from such obligation shall be treated as attributable to a noninsurance business (as defined in section 806(c)(3) of the Internal Revenue Code of 1954).

(c) STATES WHICH DETERMINE ANNUITY RESERVES WITHOUT REDUCTION FOR SURRENDER CHARGES.—If in determining minimum reserves for annuity contracts a State does not reduce such reserves for surrender charges and such State has continuously pursued this practice since September 27, 1983, then any life insurance company domiciled in such State may adjust the amount determined under section 807(d)(2) of the Internal Revenue Code of 1954 as a tax reserve for such contract by taking into account the reasonable surrender charges on such contract.

(d) DETERMINATION OF TENTATIVE LICTI WHERE CORPORATION MADE CERTAIN ACQUISITIONS IN 1980, 1981, 1982, AND 1983.—If—

(1) a corporation acquired the assets of 1 or more insurance companies after 1979 and before April 1, 1983, and

(2) the bases of such assets in the hands of the corporation were determined under section 334(b)(2) of the Internal Revenue Code of 1954 (or such corporation made an election under section 338 of such Code with respect to such assets),

then the tentative LICTI of the corporation holding such assets for taxable years beginning after December 31, 1983, and before January 1, 1986, shall, for purposes of determining the amount of the special deductions under section 806 of such Code, be increased by the deduction allowable under chapter 1 of such Code for the amortization of the cost of insurance contracts acquired in such asset acquisition (and any portion of any operations loss deduction attributable to such amortization).

(e) SPECIAL RULE FOR ALLOCATION IN CASE OF REINSURANCE AGREEMENTS.—Subsection (d) of section 811 of the Internal Revenue Code of 1954 (as amended by this title) shall not apply with respect to any contract issued before September 27, 1983, which is reinsured before such date under a reinsurance agreement entered into before such date.

(f) TREATMENT OF CERTAIN COMPANIES OPERATING BOTH AS STOCK AND MUTUAL COMPANY.—If during the 10-year period ending on December 31, 1983, a company has, as authorized by the law of the State in which the company is domiciled, been operating as a mutual life insurance company with shareholders—

(1) except as provided in paragraph (2), such company shall be treated as a stock life insurance company, and

(2) with respect to the mutual portion of its equity base, such company shall be treated as a mutual life

insurance company for purposes of sections 808(c)(2) and 809 of the Internal Revenue Code of 1954.

For purposes of the preceding sentence, the mutual portion for any calendar year of items of gain from operations, equity base, dividends to policyholders, assets, and reserves, and of other items shall be determined in the same manner as prescribed for reports filed by such company with State insurance regulatory authorities.

(g) TREATMENT OF CERTAIN ASSESSMENT LIFE INSURANCE COMPANIES.—

(1) MORTALITY AND MORBIDITY TABLES.—In the case of a contract issued by an assessment life insurance company, the mortality and morbidity tables used in computing statutory reserves for such contract shall be used for purposes of paragraph (2)(C) of section 807(d) of the Internal Revenue Code of 1954 (as amended by this subtitle) if such tables were—

(A) in use since 1965, and

(B) developed on the basis of the experience of assessment life insurance companies in the State in which such assessment life insurance company is domiciled.

(2) TREATMENT OF CERTAIN MUTUAL ASSESSMENT LIFE INSURANCE COMPANIES.—In the case of

any contract issued by a mutual assessment life insurance company which—

(A) has been in existence since 1965, and

(B) operates under chapter 13 or 14 of the Texas Insurance Code,

for purposes of part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954, the amount of the life insurance reserves for such contract shall be equal to the amount taken into account with respect to such contract in determining statutory reserves.

(3) STATUTORY RESERVES.—For purposes of this subsection, the term "statutory reserves" has the meaning given to such term by section 809(b)(4)(B) of such Code.

(h) TREATMENT OF REINSURANCE AGREEMENTS REQUIRED BY NAIC.—Effective for taxable years beginning after December 31, 1981, and before January 1, 1984, subsections (c)(1)(F) and (d)(12) of section 809 of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) shall not apply to dividends to policyholders reimbursed to the taxpayer by a reinsurer in respect of accident and health policies reinsured under a reinsurance agreement entered into before June 30, 1955, pursuant to the direction of the National Association of Insurance Commissioners and approved by the State insurance commissioner of the taxpayer's State of domicile. For purposes of subchapter L of chapter 1 of such Code (as in effect on the day before the date of the enactment of this Act) any such dividends shall be treated as dividends of the reinsurer and not the taxpayer.

(i) SPECIAL RULE FOR COMPANIES USING NET LEVEL RESERVE METHOD FOR NONCANCELABLE ACCIDENT AND HEALTH INSURANCE CONTRACTS.—A company shall be treated as meeting the requirement of section 807(d)(3)(A)(iii) of the Internal Revenue Code of 1954, as amended by this Act, with respect to any noncancelable accident and health insurance contract for any taxable year if such company—

(1) uses the net level reserve method to compute its tax reserves under section 807 of such Code on such contracts for such taxable year,

(2) was using the net level reserve method to compute its statutory reserves on such contracts as of December 31, 1982, and

(3) has continuously used such method for computing such reserves on such contracts after December 31, 1982, and through such taxable year.

Subtitle B—Taxation of Life Insurance Products

SEC. 221. DEFINITION OF LIFE INSURANCE CONTRACT.

(a) GENERAL RULE.—Chapter 79 (relating to definitions) is amended by adding at the end thereof the following new section:

"SEC. 7702. LIFE INSURANCE CONTRACT DEFINED.

"(a) GENERAL RULE.—For purposes of this title, the term 'life insurance contract' means any contract which is a life insurance contract under the applicable law, but only if such contract—

"(1) meets the cash value accumulation test of subsection (b), or

"(2)(A) meets the guideline premium requirements of subsection (c), and

"(B) falls within the cash value corridor of subsection (d).

"(b) CASH VALUE ACCUMULATION TEST FOR SUBSECTION (a)(1).—

"(1) IN GENERAL.—A contract meets the cash value accumulation test of this subsection if, by the terms of the contract, the cash surrender value of such contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.

"(2) RULES FOR APPLYING PARAGRAPH (1).—Determinations under paragraph (1) shall be made—

"(A) on the basis of interest at the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on issuance of the contract, and

"(B) on the basis of the rules of subparagraph (B)(i) (and, in the case of qualified additional benefits, subparagraph (B)(ii)) of subsection (c)(3).

"(c) GUIDELINE PREMIUM REQUIREMENTS.—For purposes of this section—

"(1) IN GENERAL.—A contract meets the guideline premium requirements of this subsection if the sum of the premiums paid under such contract does not at any time exceed the guideline premium limitation as of such time.

"(2) GUIDELINE PREMIUM LIMITATION.—The term 'guideline premium limitation' means, as of any date, the greater of—

"(A) the guideline single premium, or

"(B) the sum of the guideline level premiums to such date.

"(3) GUIDELINE SINGLE PREMIUM.—

"(A) IN GENERAL.—The term 'guideline single premium' means the premium at issue with respect to future benefits under the contract.

"(B) BASIS ON WHICH DETERMINATION IS MADE.—The determination under subparagraph (A) shall be based on—

"(i) the mortality charges specified in the contract (or, if none is specified, the mortality charges used in determining the statutory reserves for such contract),

"(ii) any charges (not taken into account under clause (i)) specified in the contract (the amount of any charge not so specified shall be treated as zero), and

"(iii) interest at the greater of an annual effective rate of 6 percent or the minumum rate or rates guaranteed on issuance of the contract.

"(C) WHEN DETERMINATION MADE.—Except as provided in subsection (f)(7), the determination under subparagraph (A) shall be made as of the time the contract is issued.

"(4) GUIDELINE LEVEL PREMIUM.—The term 'guideline level premium' means the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis as the guideline single premium, except that paragraph (3)(B)(iii) shall be applied by substituting '4 percent' for '6 percent'.

"(d) Cash Value Corridor for Purposes of Subsection (a)(2)(B).—For purposes of this section—

"(1) In general.—A contract falls within the cash value corridor of this subsection if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value.

"(2) Applicable percentage.—

"In the case of an insured with an attained age as of the beginning of the contract year of:		The applicable percentage shall decrease by a ratable portion for each full year:	
More than:	**But not more than:**	**From**	**To:**
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100.

"(e) Computational Rules.—

"(1) In general.—For purposes of this section—

"(A) the death benefit (and any qualified additional benefit) shall be deemed not to increase, "(B) the maturity date shall be no earlier than the day on which the insured attains age 95, and

"(C) the amount of any endowment benefit (or sum of endowment benefits) shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract.

"(2) LIMITED INCREASES IN DEATH BENEFIT PERMITTED.—Notwithstanding paragraph (1)(A)—

"(A) for purposes of computing the guideline level premium, an increase in the death benefit which is provided in the contract may be taken into account but only to the extent necessary to prevent a decrease in the excess of the death benefit over the cash surrender value of the contract, and

"(B) for purposes of the cash value accumulation test, the increase described in subparagraph (A) may be taken into account if the cash surrender value of the contract may not at any time exceed the net level reserve (determined as if level annual premiums were paid for the contract over a period not ending before the insured attains age 95).

"(f) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) PREMIUMS PAID.—

"(A) IN GENERAL.—The term 'premiums paid' means the premiums paid under the contract less amounts (other than amounts includible in gross income) to which section 72(e) applies.

"(B) TREATMENT OF CERTAIN PREMIUMS RETURNED TO POLICYHOLDER.—If, in order to comply with the requirements of subsection (a)(2)(A), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of a contract year, the amount so returned (excluding interest) shall be deemed to reduce the sum of the premiums paid under the contract during such year.

"(C) INTEREST RETURNED INCLUDIBLE IN GROSS INCOME.—Notwithstanding the provisions of section 72(e), the amount of any interest returned as provided in subparagraph (B) shall be includible in the gross income of the recipient.

"(2) CASH VALUES.—

"(A) CASH SURRENDER VALUE.—The cash surrender value of any contract shall be its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends.

"(B) NET SURRENDER VALUE.—The net surrender value of any contract shall be determined with regard to surrender charges but without regard to any policy loan.

"(3) DEATH BENEFIT.—The term 'death benefit' means the amount payable by reason of the death of the insured (determined without regard to any qualified additional benefits).

"(4) FUTURE BENEFITS.—The term 'future benefits' means death benefits and endowment benefits.

"(5) QUALIFIED ADDITIONAL BENEFITS.—

"(A) IN GENERAL.—The term 'qualified additional benefits' means any—

"(i) guaranteed insurability,

"(ii) accidental death or disability benefit,

"(iii) family term coverage,

"(iv) disability waiver benefit, or

"(v) other benefit prescribed under regulations.

"(B) TREATMENT OF QUALIFIED ADDITIONAL BENEFITS.—For purposes of this section, qualified additional benefits shall not be treated as future benefits under the contract, but the charges for such benefits shall be treated as future benefits.

"(C) TREATMENT OF OTHER ADDITIONAL BENEFITS.—In the case of any additional benefit which is not a qualified additional benefit—

"(i) such benefit shall not be treated as a future benefit, and

"(ii) any charge for such benefit which is not prefunded shall not be treated as a premium.

"(6) PREMIUM PAYMENTS NOT DISQUALIFYING CONTRACT.—The payment of a premium which would result in the sum of the premiums paid exceeding the guideline premium limitation shall be disregarded for purposes of subsection (a)(2) if the amount of such premium does not exceed the amount necessary to prevent the termination of the contract on or before the end of the contract year (but only if the contract will have no cash surrender value at the end of such extension period).

"(7) ADJUSTMENTS.—

"(A) IN GENERAL.—In the event of a change in the future benefits or any qualified additional benefit (or in any other terms) under the contract which was not reflected in any previous determination made under this section, under regulations prescribed by the Secretary there shall be proper adjustments in future determinations made under this section.

"(B) CERTAIN CHANGES TREATED AS EXCHANGE.—In the case of any change which reduces the future benefits under the contract, such change shall be treated as an exchange of the contract for another contract.

"(8) CORRECTION OF ERRORS.—If the taxpayer establishes to the satisfaction of the Secretary that—

"(A) the requirements described in subsection (a) for any contract year were not satisfied due to reasonable error, and

"(B) reasonable steps are being taken to remedy the error,

the Secretary may waive the failure to satisfy such requirements.

"(9) SPECIAL RULE FOR VARIABLE LIFE INSURANCE CONTRACTS.—In the case of any contract which is a variable contract (as defined in section 817), the determination of whether such contract meets the requirements of subsection (a) shall be made whenever the death benefits under such contract change but not less frequently than once during each 12-month period.

"(g) TREATMENT OF CONTRACTS WHICH DO NOT MEET SUBSECTION (a) TEST.—

"(1) INCOME INCLUSION.—

"(A) IN GENERAL.—If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year.

"(B) INCOME ON THE CONTRACT.—For purposes of this paragraph, the term 'income on the contract' means, with respect to any taxable year of the policyholder, the excess of—

"(i) the sum of—

"(I) the increase in the net surrender value of the contract during the taxable year, and

"(II) the cost of life insurance protection provided under the contract during the taxable year, over "(ii) the amount of premiums paid under the contract during the taxable year reduced by any policyholder dividends received during such taxable year.

"(C) CONTRACTS WHICH CEASE TO MEET DEFINITION.—If, during any taxable year of the policyholder, a contract which is a life insurance contract under the applicable law ceases to meet the definition of life insurance contract under subsection (a), the income on the contract for all prior taxable years shall be treated as received or accrued during the taxable year in which such cessation occurs.

"(D) COST OF LIFE INSURANCE PROTECTION.—For purposes of this paragraph, the cost of life insurance protection provided under the contract shall be the lesser of—

"(i) the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums (computed on the basis of 5-year age brackets) prescribed by the Secretary by regulations, or

"(ii) the mortality charge (if any) stated in the contract.

"(2) TREATMENT OF AMOUNT PAID ON DEATH OF INSURED.—If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the excess of the amount paid by the reason of the death of the insured over the net surrender value of the contract shall be deemed to be paid under a life insurance contract for purposes of section 101 and subtitle B.

"(3) CONTRACT CONTINUES TO BE TREATED AS INSURANCE CONTRACT.—If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), such contract shall, notwithstanding such failure, be treated as an insurance contract for purposes of this title.

"(h) ENDOWMENT CONTRACTS RECEIVE SAME TREATMENT.—

"(1) IN GENERAL.—References in subsections (a) and (g) to a life insurance contract shall be treated as including references to a contract which is an endowment contract under the applicable law.

"(2) DEFINITION OF ENDOWMENT CONTRACT.—For purposes of this title (other than paragraph (1)), the term 'endowment contract' means a contract which is an endowment contract under the applicable law and which meets the requirements of subsection (a).

"(i) TRANSITIONAL RULES FOR CERTAIN CONTRACTS ISSUED PURSUANT TO EXISTING PLANS OF INSURANCE.—

"(1) CONTRACTS ISSUED DURING 1984.—In the case of an contract which is issued during 1984 pursuant to an existing plan of insurance, such contract shall be treated as meeting the requirements of subsection (a) if—

"(A) such contract (whether or not a flexible premium contract) would meet the requirements of section 101(f),

"(B) such contract is not a flexible premium life insurance contract (within the meaning of section 101(f) and would meet the requirements of subsection (a) determined by—

"(i) substituting '3 percent' for '4 percent' in subsection (b)(2) of this section, and

"(ii) treating subparagraph (B) of subsection (e)(1) of this section as if it read as follows: 'the maturity date shall be the latest maturity date permitted under the contract, but not less than 20 years after the date of issue or (if earlier) age 95' or

"(C) under such contract—

"(i) the premiums (including any policy fees) will be adjusted from time-to-time to reflect the level amount necessary (but not less than zero) at the time of such adjustment to provide a level death benefit assuming interest crediting and an annual effective interest rate of not less than 3 percent, or

"(ii) at the option of the insured, in lieu of an adjustment under clause (i) there will be a comparable adjustment in the amount of the death benefit.

"(2) CERTAIN CONTRACTS ISSUED PURSUANT TO EXISTING PLANS OF INSURANCE.—

"(A) IN GENERAL.—In the case of a qualified 20-pay contract, this section shall be applied by substituting '3 percent' for '4 percent' in subsection (b)(2).

"(B) QUALIFIED 20-PAY CONTRACT.—For purposes of subparagraph (A), the term 'qualified 20-pay contract' means any contract which—

"(i) requires at least 20 nondecreasing annual premium payments, and

"(ii) is issued pursuant to an existing plan of insurance.

"(3) EXISTING PLAN OF INSURANCE.—For purposes of this subsection, the term 'existing plan of insurance' means, with respect to any contract, any plan of insurance which was filed by the company issuing such contract in 1 or more States before September 28, 1983, and is on file in the appropriate State for such contract.

"(j) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

(b) TECHNICAL AMENDMENTS.—

(1) Paragraph (1) of section 101(f) is amended by striking out "flexible premium life insurance contract" and inserting in lieu thereof "flexible premium life insurance contract issued before January 1, 1984".

(2) The subsection heading of subsection (f) of section 101 is amended by striking out "FLEXIBLE PREMIUM CONTRACTS" and inserting in lieu thereof "FLEXIBLE PREMIUM CONTRACTS ISSUED BEFORE JANUARY 1, 1984".

(c) CLERICAL AMENDMENT.—The table of sections for chapter 79 is amended by adding at the end thereof the following new item:

"Sec. 7702. Life insurance contract defined."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to contracts issued after December 31, 1983, in taxable years ending after such date. For purposes of the preceding sentence, in the case of a master contract, the date taken into account with respect to any insured shall be the first date on which such insured is covered under such contract.

SEC. 222. TREATMENT OF CERTAIN ANNUITY CONTRACTS.

(a) PENALTY ON PREMATURE DISTRIBUTIONS.—Paragraph (1) of section 72(q) (relating to 5-percent penalty for premature distributions from annuity contracts) is amended to read as follows:

"(1) IMPOSITION OF PENALTY.—If any taxpayer receives any amount under an annuity contract, the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 5 percent of the portion of such amount which is includible in gross income."

(b) AMOUNT OF ANNUITY CONTRACT TREATED AS DISTRIBUTED WHERE HOLDER DIES BEFORE ANNUITY STARTING DATE.—Section 72 (relating to annuities; certain proceeds of endowment and life insurance contracts) is amended by redesignating subsection (s) as subsection (t) and by inserting after subsection (r) the following new subsection:

"(s) AMOUNT OF ANNUITY CONTRACT TREATED AS DISTRIBUTED WHERE HOLDER DIES BEFORE ANNUITY STARTING DATE.—

"(1) IN GENERAL.—If the holder of any annuity contract dies before the annuity starting date, an amount equal to the cash surrender value of such contract (determined without regard to any surrender charge) shall be treated as paid to such holder immediately before his death.

"(2) EXCEPTION FOR CONTRACTS UNDER QUALIFIED PLANS.—This subsection shall not apply to any annuity contract described in subsection (e)(5)(D).

"(3) BASIS ADJUSTMENT.—For purposes of this section, in the case of any contract to which paragraph (1) applied, the amount includible in gross income by reason of paragraph (1) shall be treated as a premium paid for such contract.

"(4) PENALTY NOT TO APPLY.—Subsection (q) shall not apply to any amount includible in gross income by reason of this subsection."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to contracts issued after the day which is 6 months after the date of the enactment of this Act in taxable years ending after such date.

SEC. 223. LIMITATION ON INTEREST DEDUCTION IN CASE OF LIFE INSURANCE LOANS.

(a) GENERAL RULE.—Section 264 (relating to certain amounts paid in connection with insurance contracts) is amended by adding at the end thereof the following new subsection:

"(d) LIMITATION ON INTEREST DEDUCTION IN THE CASE OF LIFE INSURANCE LOANS.—

"(1) IN GENERAL.—The amount otherwise allowable as a deduction under this chapter for life insurance interest shall not exceed the applicable limit for the taxable year.

"(2) APPLICABLE LIMIT.—For purposes of this subsection—

"(A) IN GENERAL.—The applicable limit for any taxable year is an amount equal to the product of—

"(i) the applicable dollar amount for the taxable year, multiplied by

"(ii) the annual rate prescribed under section 6621 which is in effect as of the first day of the taxable year.

"(B) INDEFINITE CARRYOVER OF UNUSED LIMIT.—If the applicable limit for any taxable year exceeds the amount of the life insurance interest paid or accrued during such taxable year, the amount of the applicable limit for the succeeding taxable year shall be increased by the amount of such excess.

"(3) APPLICABLE DOLLAR AMOUNT.—

"(A) INDIVIDUALS.—In the case of an individual, the applicable dollar amount for any taxable year shall be $250,000 ($500,000 in the case of a joint return).

"(B) CORPORATIONS, ETC.—

"(i) IN GENERAL.—In the case of any corporation, partnership, proprietorship, or other entity engaged in a trade or business, the applicable dollar amount shall be $500,000 times the number of qualified lives.

"(ii) QUALIFIED LIVES.—For purposes of clause (i), the term 'qualified life' means any individual if—

"(I) at some time during the taxable year, the corporation, partnership, proprietorship, or other entity had a policy of life insurance (other than term) on the life of such individual and had outstanding a life insurance loan (as defined in paragraph (4) without regard to subparagraph (C) thereof) with respect to such policy, and

"(II) the face amount of such insurance policy was not less than 10 percent of the highest face amount of any policy of life insurance (other than term) which is carried by such corporation or other entity on the life of any individual and with respect to which there is outstanding a life insurance loan (as defined in paragraph (4) without regard to subparagraph (C) thereof).

"(4) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

"(A) LIFE INSURANCE INTEREST.—The term 'life insurance interest' means any interest paid or accrued on a life insurance loan which (without regard to this subsection) is allowable as a deduction under this chapter for the taxable year.

"(B) LIFE INSURANCE LOAN.—Except as provided in subparagraph (C), the term 'life insurance loan' means any indebtedness—

"(i) incurred under a life insurance, endowment, or annuity contract,

"(ii) secured by a life insurance, endowment, or annuity contract, or "(iii) incurred or continued to purchase or carry a life insurance, endowment, or annuity contract.

Such term shall not include any indebtedness the interest on which is not allowable as a deduction under this chapter for the taxable year (determined without regard to this subsection).

"(C) EXCEPTION FOR LOANS ON POLICIES ISSUED BEFORE SEPTEMBER 28, 1983.—The term 'life insurance loan' shall not include any indebtedness which (but for this subparagraph) would be a life insurance loan if the life insurance, endowment, or annuity contract referred to in subparagraph (B)—

"(i) was issued before September 28, 1983, or

"(ii) was issued on or after such date pursuant to a binding contract entered into before such date."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years ending after September 27, 1983.

SEC. 224. GROUP-TERM LIFE INSURANCE PURCHASED FOR EMPLOYEES.

(a) SECTION 79 EXTENDED TO FORMER EMPLOYEES.—

(1) Section 79 (relating to group-term insurance purchased for employees) is amended by adding at the end thereof the following new subsection:

"(e) EMPLOYEE INCLUDES FORMER EMPLOYEE.—For purposes of this section, the term 'employee' includes a former employee."

(2) Paragraph (1) of section 79(b) is amended to read as follows:

"(1) the cost of group-term life insurance on the life of an individual which is provided under a policy carried directly or indirectly by an employer after such individual has terminated his employment with such employer and is disabled (within the meaning of section 72(m)(7)),".

(b) AMOUNT OF INCLUSION IN CASE OF DISCRIMINATORY PLANS.—Paragraph (1) of section 79(d) (relating to nondiscrimination requirements) is amended to read as follows:

"(1) IN GENERAL.—In the case of a discriminatory group-term life insurance plan—

"(A) subsection (a)(1) shall not apply with respect to any key employee, and

"(B) the cost of group-term life insurance on the life of any key employee shall be determined without regard to subsection (c)."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after December 31, 1983.

(2) EXISTING GROUP-TERM LIFE INSURANCE PLANS.—The amendments made by this section shall not apply—

(A) to any group-term life insurance plan of the employer in existence on September 27, 1983, or

(B) to any group-term life insurance plan of the employer (or a successor employer) which is a comparable successor to a plan described in subparagraph (A),

but only with respect to an individual covered by the plan on such date, and in an amount not in excess of the insurance coverage of such individual on such date.

Subtitle C—Nondeductible Contributions to Individual Retirement Plans

SEC. 231. NONDEDUCTIBLE CONTRIBUTIONS PERMITTED TO INDIVIDUAL RETIREMENT PLANS.

(a) GENERAL RULE.—

(1) NONDEDUCTIBLE LIMIT TAKEN INTO ACCOUNT IN DETERMINING EXCESS CONTRIBUTIONS.—Subparagraph (B) of section 4973(b)(1) (defining excess contributions) is amended to read as follows:

"(B) the sum of the amount allowable as a deduction under section 219 for such contributions plus the nondeductible limit for the taxable year, and".

(2) DEFINITION OF NONDEDUCTIBLE LIMIT.—Section 4973 is amended by adding at the end thereof the following new subsection:

"(d) NONDEDUCTIBLE LIMIT.—

"(1) IN GENERAL.—For purposes of subsection (b), the term 'nondeductible limit' means whichever of the following is the least:

"(A) $1,750,

"(B) the excess of—

"(i) the compensation (as defined in section 219(e)(1)) includible in the individual's gross income for the taxable year, over

"(ii) the maximum amount allowable as a deduction under section 219 for such taxable year to the individual, or

"(C) the amount of the designated nondeductible contributions for the taxable year.

"(2) DESIGNATED NONDEDUCTIBLE CONTRIBUTION.—

"(A) IN GENERAL.—For purposes of paragraph (1), the term 'designated nondeductible contribution' means any contribution to an individual retirement plan for the taxable year which is designated as a nondeductible contribution.

"(B) DESIGNATION.—Any designation under subparagraph (A) may be made (or revoked) at any time before the last day prescribed by law for filing the return of tax imposed by subtitle A for the taxable year (including extensions thereof).

"(3) SPECIAL RULE FOR SPOUSAL IRA.—In the case of an individual to whom a deduction is allowable under section 219(c) for any taxable year, the nondeductible limit for such year shall be determined by reference to such individual's compensation and shall be allocated between the spouses in such manner as they may designate."

(3) CONFORMING AMENDMENT.—Subparagraph (C) of section 4973(b)(2) is amended to read as follows:

"(C) the excess (if any) of—

"(i) the sum of the maximum amount allowable as a deduction under section 219 for the taxable year plus the nondeductible limit for the taxable year, over

"(ii) the amount contributed (determined without regard to section 219(e)(6)) to the accounts or for the annuities for the taxable year."

(b) TREATMENT OF DISTRIBUTIONS.—Paragraphs (1) and (2) of section 408(d) (relating to tax treatment of distributions) are amended to read as follows:

"(1) IN GENERAL.—Except as otherwise provided in this subsection, any amount paid or distributed out of an individual retirement account or under an individual retirement annuity shall—

"(A) first be treated as paid or distributed out of income and gains attributable to designated nondeductible contributions (to the extent thereof), "(B) second be treated as paid or distributed out of designated nondeductible contributions (to the extent thereof), and

"(C) then be treated as paid or distributed out of other amounts.

"(2) TREATMENT OF DISTRIBUTIONS.—

"(A) ORDINARY INCOME AMOUNTS.—Any amount to which subparagraph (A) or (C) of paragraph (1) applies shall be included in gross income by the payee or distributee (as the case may be) for the taxable year in which the payment or distribution is received.

"(B) BASIS RECOVERY.—Any amount to which subparagraph (B) of paragraph (1) applies shall be excluded from gross income.

"(C) DISTRIBUTIONS OF ANNUITY CONTRACTS.—Paragraph (1) shall not apply to the distribution from an individual retirement account of an annuity contract which meets the requirements of paragraphs (1), (3), (4), and (5) of subsection (b); except that paragraph (1) shall apply to any distributions under such contract.

"(D) LOSS.—If—

"(i) the aggregate amount of designated nondeductible contributions to any individual retirement account or annuity, exceeds

"(ii) the aggregate amount paid or distributed out of such account or under such annuity,

an amount equal to such excess shall be allowed as a deduction to the individual for the last taxable year in which such account or annuity is in existence."

(c) INFORMATION REQUIREMENTS.—

(1) INDIVIDUAL RETIREMENT ACCOUNTS.—Subsection (a) of section 408 (defining individual retirement accounts) is amended by adding at the end thereof the following new paragraph:

"(8) The trustee maintains such records as may be necessary to separately account for designated nondeductible contributions and for income and gains attributable to such contributions."

(2) INDIVIDUAL RETIREMENT ANNUITIES.—Subsection (b) of section 408 is amended by inserting after paragraph (5) the following new paragraph:

"(6) The issuer of such contract maintains such records as may be necessary to separately account for designated nondeductible contributions and for income and gains attributable to such contributions."

(d) TECHNICAL AMENDMENTS.—

(1) DISALLOWANCE OF DEDUCTION FOR DESIGNATED NONDEDUCTIBLE CONTRIBUTION.—Subsection (d) of section 219 (relating to other limitations and restrictions) is amended by adding at the end thereof the following new paragraph:

"(5) DENIAL OF DEDUCTION FOR DESIGNATED NONDEDUCTIBLE CONTRIBUTIONS.—No deduction shall be allowed under this section with respect to any designated nondeductible contribution (as defined in section 4973(d)(2))."

(2) INCREASE IN LIMITATIONS ON AMOUNT INDIVIDUAL RETIREMENT PLAN CAN ACCEPT.—

(A) The following provisions are each amended by striking out "$2,000" each place it appears and inserting in lieu thereof "$3,750":

(i) Section 408(a)(1).

(ii) Section 408(b).

(iii) Section 408(j).

(B) Subparagraph (A) of section 408(d)(5) is amended by striking out "$2,250" and inserting in lieu thereof "$4,000".

(3) SEPARATE RECORDS REQUIRED IN CASE OF ROLLOVER CONTRIBUTIONS.—Paragraph (3) of section 408(d) (relating to rollover amounts) is amended by adding at the end thereof the following new subparagraph:

"(E) SEPARATE REPORTING FOR AMOUNTS ATTRIBUTABLE TO DESIGNATED NONDEDUCTIBLE CONTRIBUTIONS.—For purposes of this paragraph, the Secretary shall prescribe regulations providing for such allocations of amounts attributable to designated nondeductible contributions (as defined in section 4973(d)(2)) as may be necessary to ensure that the separate treatment of such contributions and the income and gain attributable to such contributions is maintained."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to contributions made during taxable years beginning after December 31, 1983.

Subtitle D—Studies

SEC. 241. STUDIES.

(a) REVENUE REPORTS.—Not later than July 1, 1984, and July 1 of each calendar year thereafter, the Secretary of the Treasury shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on—

(1) the aggregate amount of revenue received under part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954 for the most recent taxable years for which data are available,

(2) a comparison between the amount of such revenue and the amount anticipated by reason of changes made by the Tax Equity and Fiscal Responsibility Act of 1982 or the Life Insurance Tax Act of 1983, and

(3) the reasons for any difference between such aggregate revenues and anticipated revenues.

(b) REPORT WITH RESPECT TO SEGMENT BALANCE, ETC.—

(1) IN GENERAL.—The Secretary of the Treasury (in consultation with the Joint Committee on Taxation, the Committee on Ways and Means of the House of Representatives, and the Committee on Finance of the Senate) shall conduct a full and complete study of the operation of part I of subchapter L of chapter 1 of the Internal Revenue Code of 1954 during 1984, 1985, and 1986. Such study shall also include an analysis of life insurance products and the taxation thereof. Such study shall also include an analysis of whether part I of such subchapter L operates as a disincentive to growing companies.

(2) ITEMS TO BE INCLUDED.—The study conducted under paragraph (1) shall include—

(A) an analysis of the portion of the taxes paid by mutual life insurance companies and stock life insurance companies, and

(B) any other data considered relevant by either stock life insurance companies or mutual life insurance companies in determining appropriate segment balance, such as the respective amounts of the following items held by each segment of the industry—

(i) equity,

(ii) life insurance reserves,

(iii) other types of reserves,

(iv) dividends paid to policyholders and shareholders,

(v) pension business,

(vi) total assets, and

(vii) gross receipts.

Such report shall also include an analysis of the extent to which taxes paid by stockholders of life insurance companies shall be included in analyzing segment balance.

(3) REPORTS.—

(A) INTERIM REPORTS.—The Secretary of the Treasury shall submit interim reports on the study conducted under this subsection to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate not later than July 1, 1986, 1987, and 1988.

(B) FINAL REPORT.—Not later than January 1, 1989, the Secretary of the Treasury shall submit a final report on the study conducted under this subsection to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

(c) AUTHORITY TO REQUIRE DATA.—The Secretary of the Treasury shall have authority to require reporting of such data with respect to life insurance companies and their products as may be necessary to carry out the purposes of this section.

TITLE III—REVISION OF PRIVATE FOUNDATION PROVISIONS

SEC. 301. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This title may be cited as the "Private Foundation Tax Treatment Revision Act of 1984".

(b) TABLE OF CONTENTS.—

Sec. 301. Short title; table of contents.
Sec. 302. Limitations on deduction for contributions to private foundations.
Sec. 303. Exemption for certain operating foundations from excise tax on investment income.

Sec. 304. Reduction in excise tax on investment income where private foundation meets certain distribution requirements.
Sec. 305. Amendment to taxes on failure to distribute income.
Sec. 306. Abatement of first tier taxes in certain cases.
Sec. 307. Miscellaneous amendments.
Sec. 308. 5-year extension of requirements to dispose of certain excess holdings attributable to large gifts and bequests.
Sec. 309. Decreases attributable to stock issuances not to reduce permitted percentage of holdings where decrease is 2 percent or less.
Sec. 310. Aggregation of stock holdings of private foundation and disqualified persons in applying 95 percent ownership test.
Sec. 311. 5-year period to dispose of excess holdings resulting from certain acquisitions by disqualified persons.
Sec. 312. The conducting of certain games of chance not treated as unrelated trade or business.
Sec. 313. Tax on self-dealing not to apply to certain stock purchases.
Sec. 314. Person ceases to be substantial contributor after 10 years with no connection to foundation.
Sec. 315. Technical amendments.

SEC. 302. LIMITATIONS ON DEDUCTION FOR CONTRIBUTIONS TO PRIVATE FOUNDATIONS.

(a) Increase in Percentage Limitation for Individuals.—

(1) In general.—Clause (i) of section 170(b)(1)(B) (relating to percentage limitations for individuals) is amended by striking out "20 percent" and inserting in lieu thereof "30 percent".

(2) Carryover of excess contributions.—Subparagraph (B) of section 170(b)(1) is amended by adding at the end thereof the following new sentence:

"If the aggregate of such contributions exceeds the limitation of the preceding sentence, such excess shall be treated (in a manner consistent with the rules of subsection (d)(1)) as a charitable contribution (to which subparagraph (A) does not apply) in each of the 5 succeeding taxable years in order of time."

(b) DEDUCTION ALLOWED FOR FULL FAIR MARKET VALUE OF CERTAIN STOCK CONTRIBUTED TO PRIVATE FOUNDATIONS.—Subsection (e) of section 170 (relating to certain contributions of ordinary income and capital gain property) is amended by adding at the end thereof the following new paragraph:

"(5) SPECIAL RULE FOR CONTRIBUTIONS OF STOCK FOR WHICH MARKET QUOTATIONS ARE READILY AVAILABLE.—

"(A) IN GENERAL.—Subparagraph (B)(ii) of paragraph (1) shall not apply to any contribution of qualified appreciated stock.

"(B) QUALIFIED APPRECIATED STOCK.—Except as provided in subparagraph (C), for purposes of this paragraph, the term 'qualified appreciated stock' means any stock of a corporation—

"(i) for which (as of the date of the contribution) market quotations are readily available on an established securities market, and

"(ii) which is capital gain property (as defined in subsection (b)(1)(C)(iv)).

"(C) DONOR MAY NOT CONTRIBUTE MORE THAN 10 PERCENT OF STOCK OF CORPORATION.—

"(i) IN GENERAL.—In the case of any donor, the term 'qualified appreciated stock' shall not include any stock of a corporation contributed by the donor in a contribution to which paragraph (1)(B)(ii) applies (determined without regard to this paragraph) to the extent that the amount of the stock so contributed (when increased by the aggregate amount of all prior such contributions by the donor of stock in such corporation) exceeds 10 percent (in value) of all of the outstanding stock of such corporation.

"(ii) SPECIAL RULE.—For purposes of clause (i), an individual shall be treated as making all contributions made by any member of his family (as defined in section 267(c)(4)).

"(D) TERMINATION.—This paragraph shall not apply to contributions made after December 31, 1994."

(c) 20-PERCENT LIMITATION RETAINED FOR CONTRIBUTIONS OF CAPITAL GAIN PROPERTY.—

(1) IN GENERAL.—Paragraph (1) of section 170(b) (relating to percentage limitations for individuals) is amended by redesignating subparagraphs (D) and (E) as subparagraphs (E) and (F), respectively, and by inserting after subparagraph (C) the following new subparagraph:

"(D) SPECIAL LIMITATION WITH RESPECT TO CONTRIBUTIONS OF CAPITAL GAIN PROPERTY TO ORGANIZATIONS NOT DESCRIBED IN SUBPARAGRAPH (A).—

"(i) IN GENERAL.—In the case of charitable contributions (other than charitable contributions to which subparagraph (A) applies) of capital gain property, the total amount of such contributions of such property taken into account under subsection (a) for any taxable year shall not exceed the lesser of—

"(I) 20 percent of the taxpayer's contribution base for the taxable year, or

"(II) the excess of 30 percent of the taxpayer's contribution base for the taxable year over the amount of the contributions of capital gain property to which subparagraph (C) applies.

For purposes of this subsection, contributions of capital gain property to which this subparagraph applies shall be taken into account after all other charitable contributions.

"(ii) CARRYOVER.—If the aggregate amount of contributions described in clause (i) exceeds the limitation of clause (i), such excess shall be treated (in a manner consistent with the rules of subsection (d)(1)) as a charitable contribution of capital gain property to which clause (i) applies in each of the 5 succeeding taxable years in order of time."

(2) TECHNICAL AMENDMENTS.—

(A) Clause (vii) of section 170(b)(1)(A) is amended by striking out "subparagraph (D)" and inserting in lieu thereof "subparagraph (E)".

(B) The subparagraph heading and clause (i) of subparagraph (C) of section 170(b)(1) are amended to read as follows:

"(C) SPECIAL LIMITATION WITH RESPECT TO CONTRIBUTIONS DESCRIBED IN SUBPARAGRAPH (A) OF CERTAIN CAPITAL GAIN PROPERTY.—

"(i) In the case of charitable contributions described in subparagraph (A) of capital gain property to which subsection (e)(1)(B) does not apply, the total amount of contributions of such property which may be taken into account under subsection (a) for any taxable year shall not exceed 30 percent of the taxpayer's contribution base for such year. For purposes of this subsection, contributions of capital gain property to which this subparagraph applies shall be taken into account after all other charitable contributions (other than charitable contributions to which subparagraph (D) applies)."

(C) Subparagraph (B) of section 170(e)(1) is amended by striking out "subsection (b)(1)(D)" and inserting in lieu thereof "subsection (b)(1)(E)".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to contributions made in taxable years beginning after December 31, 1984.

SEC. 303. EXEMPTION FOR CERTAIN OPERATING FOUNDATIONS FROM EXCISE TAX ON INVESTMENT INCOME.

(a) GENERAL RULE.—Section 4940 (relating to excise tax based on investment income) is amended by adding at the end thereof the following new subsection:

"(d) EXEMPTION FOR CERTAIN OPERATING FOUNDATIONS.—

"(1) IN GENERAL.—No tax shall be imposed by this section on any private foundation which is an exempt operating foundation for the taxable year.

"(2) EXEMPT OPERATING FOUNDATION.—For purposes of this subsection, the term 'exempt operating foundation' means, with respect to any taxable year, any private foundation if—

"(A) such foundation is an operating foundation (as defined in section 4942(j)(3)),

"(B) such foundation has been publicly supported for at least 10 taxable years,

"(C) at all times during the taxable year, the governing body of such foundation—

"(i) consists of individuals at least 75 percent of whom are not disqualified individuals, and

"(ii) is broadly representative of the general public, and

"(D) at no time during the taxable year does such foundation have an officer who is a disqualified individual.

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) PUBLICLY SUPPORTED.—A private foundation is publicly supported for a taxable year if it meets the requirements of section 170(b)(1)(A)(vi) or 509(a)(2) for such taxable year.

"(B) DISQUALIFIED INDIVIDUAL.—The term 'disqualified individual' means, with respect to any private foundation, an individual who is—

"(i) a substantial contributor to the foundation,

"(ii) an owner of more than 20 percent of—

"(I) the total combined voting power of a corporation,

"(II) the profits interest of a partnership, or

"(III) the beneficial interest of a trust or unincorporated enterprise,

which is a substantial contributor to the foundation, or "(iii) a member of the family of any individual described in clause (i) or (ii).

"(C) SUBSTANTIAL CONTRIBUTOR.—The term 'substantial contributor' means a person who is described in section 507(d)(2).

"(D) FAMILY.—The term 'family' has the meaning given to such term by section 4946(d).

"(E) CONSTRUCTIVE OWNERSHIP.—The rules of paragraphs (3) and (4) of section 4946(a) shall apply for purposes of subparagraph (B)(ii)."

(b) REQUIREMENT OF EXPENDITURE RESPONSIBILITY NOT TO APPLY TO CERTAIN OPERATING FOUNDATIONS.—Paragraph (4) of section 4945(d) (defining taxable expenditure) is amended to read as follows:

"(4) as a grant to an organization unless—

"(A) such organization is described in paragraph (1), (2), or (3) of section 509(a) or is an exempt operating foundation (as defined in section 4940(d)(2)), or

"(B) the private foundation exercises expenditure responsibility with respect to such grant in accordance with subsection (h), or".

(c) EFFECTIVE DATE.—

(1) FOR SUBSECTION (a).—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

(2) FOR SUBSECTION (b).—The amendment made by subsection (b) shall apply to grants made after December 31, 1984, in taxable years ending after such date.

(3) CERTAIN EXISTING FOUNDATIONS.—A foundation which was an operating foundation (as defined in section 4942(j)(3) of the Internal Revenue Code of 1954) as of January 1, 1983, shall be treated as meeting the requirements of section 4940(d)(2)(B) of such Code (as added by subsection (a)).

SEC. 304. REDUCTION IN EXCISE TAX ON INVESTMENT INCOME WHERE PRIVATE FOUNDATION MEETS CERTAIN DISTRIBUTION REQUIREMENTS.

(a) GENERAL RULE.—Section 4940 (relating to excise tax based on investment income) is amended by adding at the end thereof the following new subsection:

"(e) REDUCTION IN TAX WHERE PRIVATE FOUNDATION MEETS CERTAIN DISTRIBUTION REQUIREMENTS.—

"(1) IN GENERAL.—In the case of any private foundation which meets the requirements of paragraph (2) for any taxable year, subsection (a) shall be applied with respect to such taxable year by substituting '1 percent' for '2 percent'.

"(2) REQUIREMENTS.—A private foundation meets the requirements of this paragraph for any taxable year if—

"(A) the amount of the qualifying distributions made by the private foundation during such taxable year equals or exceeds the sum of—

"(i) an amount equal to the assets of such foundation for such taxable year multiplied by the average percentage payout for the base period, plus

"(ii) 1 percent of the net investment income of such foundation for such taxable year, and

"(B) the average percentage payout for the base period equals or exceeds 5 percent.

In the case of an operating foundation (as defined in section 4942(j)(3)), subparagraph (B) shall be applied by substituting '3⅓ percent' for '5 percent'.

"(3) AVERAGE PERCENTAGE PAYOUT FOR BASE PERIOD.—For purposes of this subsection—

"(A) IN GENERAL.—The average percentage payout for the base period is the average of the percentage payouts for taxable years in the base period.

"(B) PERCENTAGE PAYOUT.—The term 'percentage payout' means, with respect to any taxable year, the percentage determined by dividing—

"(i) the amount of the qualifying distributions made by the private foundation during the taxable year, by

"(ii) the assets of the private foundation for the taxable year.

"(C) SPECIAL RULE WHERE TAX REDUCED UNDER THIS SUBSECTION.—For purposes of this paragraph, if the amount of the tax imposed by this section for any taxable year in the base period is reduced by reason of this subsection, the amount of the qualifying distributions made by the private foundation during such year shall be reduced by the amount of such reduction in tax.

"(4) BASE PERIOD.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'base period' means, with respect to any taxable year, the 5 taxable years preceding such taxable year.

"(B) NEW PRIVATE FOUNDATIONS, ETC.—If an organization has not been a private foundation throughout the base period referred to in subparagraph (A), the base period shall consist of the taxable years during which such foundation has been in existence.

"(5) OTHER DEFINITIONS.—For purposes of this subsection—

"(A) QUALIFYING DISTRIBUTION.—The term 'qualifying distribution' has the meaning given such term by section 4942(g).

"(B) ASSETS.—The assets of a private foundation for any taxable year shall be treated as equal to the excess determined under section 4942(e)(1).

"(6) TREATMENT OF SUCCESSOR ORGANIZATIONS, ETC.—In the case of—

"(A) a private foundation which is a successor to another private foundation, this subsection shall be applied with respect to such successor by taking into account the experience of such other foundation, and

"(B) a merger, reorganization, or division of a private foundation, this subsection shall be applied under regulations prescribed by the Secretary."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

SEC. 305. AMENDMENT TO TAXES ON FAILURE TO DISTRIBUTE INCOME.

(a) LIMIT ON AMOUNT OF CERTAIN ADMINISTRATIVE EXPENSES TAKEN INTO ACCOUNT AS QUALIFYING DISTRIBUTIONS.—Subsection (g) of section 4942 (defining qualified distributions) is amended by adding at the end thereof the following new paragraph:

"(4) LIMITATION ON ADMINISTRATIVE EXPENSES ALLOCABLE TO MAKING OF CONTRIBUTIONS, GIFTS, AND GRANTS.—

"(A) IN GENERAL.—The amount of the grant administrative expenses paid during any taxable year which may be taken into account as qualifying distributions shall not exceed the excess (if any) of—

"(i) 15 percent of the aggregate amount of qualified grants made by the private foundation during such taxable year and the immediately preceding 4 taxable years, over "(ii) the aggregate amount of grant administrative expenses paid during the 4 preceding taxable years which were taken into account as qualified distributions.

"(B) GRANT ADMINISTRATIVE EXPENSES.—For purposes of this paragraph, the term 'grant administrative expenses' means any administrative expenses which are allocable to the making of qualified grants.

"(C) QUALIFIED GRANTS.—For purposes of this paragraph, the term 'qualified grant' means any contribution, gift, or grant which is a qualifying distribution.

"(D) TRANSITIONAL RULE.—In the case of any preceding taxable year which began before January 1, 1985, the amount of the grant administrative expenses taken into account under subparagraph (A)(ii) shall not exceed 15 percent of the qualified grants made by the foundation during such taxable year."

(b) REQUIRED DISTRIBUTION INCREASED BY AMOUNT OF CERTAIN REPAYMENTS, ETC.—Paragraph (1) of section 4942(d) (defining distributable amount) is amended to read as follows:

"(1) the sum of the minimum investment return plus the amounts described in subsection (f)(2)(C), reduced by".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984.

SEC. 306. ABATEMENT OF FIRST TIER TAXES IN CERTAIN CASES.

(a) GENERAL RULE.—Subchapter C of chapter 42 (relating to abatement of second tier taxes) is amended by redesignating section 4962 as section 4963 and by inserting after section 4961 the following new section:

"SEC. 4962. ABATEMENT OF PRIVATE FOUNDATION FIRST TIER TAXES IN CERTAIN CASES.

"(a) GENERAL RULE.—If it is established to the satisfaction of the Secretary that—

"(1) a taxable event was due to reasonable cause and not to willful neglect, and

"(2) such event was corrected within the correction period for such event,

then any private foundation first tier tax imposed with respect to such event (including interest) shall not be assessed and, if assessed, the assessment shall be abated and, if collected, shall be credited or refunded as an overpayment.

“(b) Private Foundation First Tier Tax.—For purposes of this section, the term ‘private foundation first tier tax’ means any first tier tax imposed by subchapter A of chapter 42, except that such term shall not include the tax imposed by section 4941(a) (relating to initial tax on self-dealing).”

(b) Conforming Amendments.—

(1) The heading of subchapter C of chapter 42 is amended to read as follows:

“Subchapter C—Abatement of First and Second Tier Taxes in Certain Cases”.

(2) The table of sections for subchapter C of chapter 42 is amended by striking out the item relating to section 4962 and inserting in lieu thereof the following:

“Sec. 4962. Abatement of private foundation first tier taxes in certain cases.
“Sec. 4963. Definitions.”

(3) The table of subchapters for chapter 42 is amended by striking out the item relating to subchapter C and inserting in lieu thereof the following:

“Subchapter C. Abatement of first and second tier taxes in certain cases.”

(4) Sections 4942(g)(2)(C), 6213(e), and 6503(g) are each amended by striking out “section 4962(e)” and inserting in lieu thereof “section 4963(e)”.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable events occurring after December 31, 1984.

SEC. 307. MISCELLANEOUS AMENDMENTS.

(a) REPEAL OF REQUIREMENT THAT VOTER REGISTRATION ACTIVITIES BE CARRIED ON IN 5 OR MORE STATES.—Paragraph (2) of section 4945(f) (relating to nonpartisan activities carried on by certain organizations) is amended to read as follows:

"(2) the activities of which are nonpartisan and are not confined to 1 specific election period,".

(b) DEFINITION OF FAMILY MEMBER.—Subsection (d) of section 4946 (defining members of family) is amended to read as follows:

"(d) MEMBERS OF FAMILY.—For purposes of subsection (a)(1), the family of any individual shall include only his spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren."

(c) REQUIREMENT THAT ANNUAL NOTICE INCLUDE TELEPHONE NUMBER OF THE PRIVATE FOUNDATION.—Subsection (d) of section 6104 (relating to public inspection of private foundations' annual returns) is amended by striking out "shall state the address of the private foundation's principal office" and inserting in lieu thereof "shall state the address and the telephone number of the private foundation's principal office".

(d) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall take effect on January 1, 1984.

(2) SUBSECTIONS (b) AND (c).—The amendments made by subsections (b) and (c) shall take effect on January 1, 1985.

SEC. 308. 5-YEAR EXTENSION OF REQUIREMENT TO DISPOSE OF CERTAIN EXCESS HOLDINGS ATTRIBUTABLE TO LARGE GIFTS AND BEQUESTS.

(a) GENERAL RULE.—Subsection (c) of section 4943 (relating to taxes on excess business holdings) is amended by adding at the end thereof the following new paragraph:

"(7) 5-YEAR EXTENSION OF PERIOD TO DISPOSE OF CERTAIN LARGE GIFTS AND BEQUESTS.—The Secretary may extend for an additional 5-year period the period under paragraph (6) for disposing of excess business holdings in the case of an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures if the foundation—

"(A) establishes that—

"(i) diligent efforts to dispose of such holdings have been made within the initial 5-year period, and "(ii) disposition within the initial 5-year period has not been possible (except at a price substantially below fair market value) by reason of such size and complexity or diversity of such holdings, and

"(B)(i) before the close of the initial 5-year period, has submitted a plan to the Secretary for disposing of all of the excess business holdings involved in the extension, and

"(ii) the Secretary determines that such plan can reasonably be expected to be carried out before the close of the extension period."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to business holdings with respect to which the 5-year period described in section 4943(c)(6) of the Internal Revenue Code of 1954 ends on or after November 1, 1983.

(2) TRANSITIONAL RULE.—Any plan submitted to the Secretary of the Treasury or his delegate on or before the 60th day after the date of the enactment of this Act shall be treated as submitted before the close of the initial 5-year period referred to in section 4943(c)(7)(B) of the Internal Revenue Code of 1954 (as added by subsection (a)).

SEC. 309. DECREASES ATTRIBUTABLE TO STOCK ISSUANCES NOT TO REDUCE PERMITTED PERCENTAGE OF HOLDINGS WHERE DECREASE IS 2 PERCENT OR LESS.

(a) GENERAL RULE.—The second sentence of clause (ii) of section 4943(c)(4)(A) (relating to present holdings) is amended to read as follows:

> "For purposes of the preceding sentence, any decrease in percentage holdings attributable to issuances of stock (or to issuances of stock coupled with redemptions of stock) shall be disregarded so long as—
>
> "(I) the net percentage decrease disregarded under this sentence does not exceed 2 percent, and
>
> "(II) the number of shares held by the foundation is not affected by any such issuance or redemption."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to increases and decreases after the date of the enactment of this Act.

SEC. 310. AGGREGATION OF STOCK HOLDINGS OF PRIVATE FOUNDATION AND DISQUALIFIED PERSONS IN APPLYING 95 PERCENT OWNERSHIP TEST.

(a) GENERAL RULE.—Clause (i) of section 4943(c)(4)(B) (relating to present holdings) is amended by striking out "the private foundation has" and inserting in lieu thereof "the private foundation and all disqualified persons have".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 311. 5-YEAR PERIOD TO DISPOSE OF EXCESS HOLDINGS RESULTING FROM CERTAIN ACQUISITIONS BY DISQUALIFIED PERSONS.

(a) GENERAL RULE.—Paragraph (6) of section 4943(c) (relating to 5-year period to dispose of gifts, bequests, etc.) is amended by adding at the end thereof the following new sentence:

> "In any case where an acquisition by a disqualified person would result in a substitution under clause (i) or (ii) of subparagraph (D) of paragraph (4), the preceding sentence shall be applied with respect to such acquisition as if it did not contain the phrase 'or by a disqualified person' in the material preceding subparagraph (A)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to acquisitions after the date of the enactment of this Act.

SEC. 312. THE CONDUCTING OF CERTAIN GAMES OF CHANCE NOT TREATED AS UNRELATED TRADE OR BUSINESS.

(a) GENERAL RULE.—For purposes of section 513 of the Internal Revenue Code of 1954 (defining unrelated trade or business), the term "unrelated trade or business" does not include any trade or business which consists of conducting any game of chance if—

(1) such game of chance is conducted by a nonprofit organization,

(2) the conducting of such game by such organization does not violate any State or local law, and

(3) as of October 5, 1983—

(A) there was a State law in effect which permitted the conducting of such game of chance by such nonprofit organization, but

(B) the conducting of such game of chance by organizations which were not nonprofit organizations would have violated such law.

(b) EFFECTIVE DATE.—Subsection (a) shall apply to games of chance conducted after June 30, 1981, in taxable years ending after such date.

SEC. 313. TAX ON SELF-DEALING NOT TO APPLY TO CERTAIN STOCK PURCHASES.

(a) GENERAL RULE.—Section 4941 of the Internal Revenue Code of 1954 (relating to taxes on self-dealing) shall not apply to the purchase during 1978 of stock from a private foundation (and to any note issued in connection with such purchase) if—

(1) consideration for such purchase equaled or exceeded the fair market value of such stock,

(2) the purchaser of such stock did not make any contribution to such foundation at any time during the 5-year period ending on the date of such purchase,

(3) the aggregate contributions to such foundation by the purchaser before such date were less than $10,000 and less than 2 percent of the total contributions received by the foundation as of such date, and

(4) such purchase was pursuant to the settlement of litigation involving the purchaser.

(b) STATUTE OF LIMITATIONS.—If credit or refund of any overpayment of tax resulting from subsection (a) is prevented at any time before the close of the 1-year period beginning on the date of the enactment of this Act by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed before the close of such 1-year period.

SEC. 314. PERSON CEASES TO BE SUBSTANTIAL CONTRIBUTOR AFTER 10 YEARS WITH NO CONNECTION TO FOUNDATION.

(a) GENERAL RULE.—Paragraph (2) of section 507(d) (defining substantial contributor) is amended by adding at the end thereof the following new subparagraph:

"(C) PERSON CEASES TO BE SUBSTANTIAL CONTRIBUTOR IN CERTAIN CASES.—

"(i) IN GENERAL.—A person shall cease to be treated as a substantial contributor with respect to any private foundation as of the close of any taxable year of such foundation if—

"(I) during the 10-year period ending at the close of such taxable year such person (and all related persons) have not made any contribution to such private foundation,

"(II) at no time during such 10-year period was such person (or any related person) a foundation manager of such private foundation, and

"(III) the aggregate contributions made by such person (and related persons) are determined by the Secretary to be insignificant when compared to the aggregate amount of contributions to such foundation by one other person.

For purposes of subclause (III), appreciation on contributions while held by the foundation shall be taken into account.

"(ii) RELATED PERSON.—For purposes of clause (i), the term 'related person' means, with respect to any person, any other person who would be a disqualified person (within the meaning of section 4946) by reason of his relationship to such person. In the case of a contributor which is a corporation, the term also includes any officer or director of such corporation."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

SEC. 315. TECHNICAL AMENDMENTS.

(a) AMENDMENTS OF INTERNAL REVENUE CODE OF 1954.—

(1) Subparagraph (B) of section 4942(a)(2) (relating to taxes on failure to distribute income) is amended by striking out "subsection (j)(4)" and inserting in lieu thereof "subsection (j)(2)".

(2) Paragraph (1) of section 4942(f) (defining adjusted net income) is amended by striking out "subsection (d)" and inserting in lieu thereof "subsection (j)".

(3) Paragraph (3) of section 6501(n) (relating to special rule for chapter 42 and similar taxes) is amended by striking out "section 4942(g)(2)(B)(i)(II)" and inserting in lieu thereof "section 4942(g)(2)(B)(ii)".

(4) The amendments made by this subsection shall take effect on the date of the enactment of this Act.

(b) AMENDMENT OF 1969 TAX REFORM ACT.—

(1) Subparagraph (A) of section 101(l)(4) of the Tax Reform Act of 1969 is amended by striking out "by substituting '51 percent' for '50 percent' " and inserting in lieu thereof "as if it did not contain the phrase ', but in no event shall the percentage so substituted be more than 50 percent' ".

(2) The amendment made by paragraph (1) shall apply as if included in section 101(l)(4) of the Tax Reform Act of 1969.

TITLE IV—TAX SIMPLIFICATION

SEC. 401. SHORT TITLE; ETC.

(a) SHORT TITLE.—This title may be cited as the "Tax Law Simplification and Improvement Act of 1984".

(b) TABLE OF CONTENTS.—

TITLE IV—TAX SIMPLIFICATION

Sec. 401. Short title; etc.

Subtitle A—Revision and Simplification of Estimated Income Tax for Individuals

Sec. 411. Revision of penalty for failure to pay estimated income tax.
Sec. 412. Repeal of requirement of declarations, etc.
Sec. 413. Crediting of income tax overpayment against estimated tax liability.
Sec. 414. Effective date.

Subtitle B—Domestic Relations

Sec. 421. Short title.
Sec. 422. Treatment of transfers of property between spouses or incident to divorce.
Sec. 423. Tax treatment of alimony and separate maintenance payments.
Sec. 424. Dependency exemption in the case of child of divorced parents, etc.
Sec. 425. Innocent spouse relieved of liability in certain cases.
Sec. 426. Treatment of certain property settlements for purposes of estate and gift taxes.
Sec. 427. Income from sheltered workshops not taken into account in determining dependency exemption.

Subtitle C—Revision of At-Risk Rules

Sec. 431. Revision of investment credit at-risk rules.
Sec. 432. Exclusion of active businesses of qualified C corporations from at-risk rules, etc.

Subtitle D—Estate Tax Provisions

Sec. 441. Permanent rules for reforming governing instruments creating charitable remainder trusts and other charitable interests.
Sec. 442. Alternate valuation election available only where it results in reduction of gross estate and estate tax.
Sec. 443. Alternate valuation election available on late return.

Subtitle E—Foreign Tax Provisions

Sec. 451. Definition of resident alien and nonresident alien.
Sec. 452. Treatment of community income.
Sec. 453. Amendments related to foreign personal holding companies.
Sec. 454. Amendments related to section 1248.
Sec. 455. Coordination of subpart F with foreign personal holding company provisions.
Sec. 456. Stapled stock; stapled entities.

Subtitle F—Miscellaneous Treasury Administrative Provisions

PART I—PROVISIONS NOT RELATING TO DISTILLED SPIRITS TAX

Sec. 461. Simplification of certain reporting requirements.
Sec. 462. Removal of $1,000,000 limitation on working capital fund.
Sec. 463. Increase in limitation on revolving fund for redemption of real property.
Sec. 464. Removal of $1,000,000 limitation on special authority to dispose of obligations.
Sec. 465. Secretary of the Treasury authorized to accept gifts and bequests.
Sec. 466. Extension of period for court review of jeopardy assessment where prompt service not made on the United States.
Sec. 467. Extension of period during which additional tax shown on amended return may be assessed.

Sec. 468. Treatment of certain guaranteed drafts issued by financial institutions.
Sec. 469. Disclosure of windfall profit tax information to State tax officials.

PART II—PROVISIONS RELATING TO DISTILLED SPIRITS

Sec. 470. Repeal of occupational tax on manufacturers of stills and condensers; notices of manufacture and set up of stills.
Sec. 471. Allowance of drawback claims even where certain requirements not met.
Sec. 472. Disclosure of alcohol fuel producers to administrators of State alcohol laws.
Sec. 473. Repeal of stamp requirement for distilled spirits.
Sec. 474. Effective dates.

Subtitle G—Tax Court Provisions

Sec. 475. Certified public accountants and enrolled agents authorized to represent taxpayers in small tax cases; increase in jurisdictional limit for small tax cases.
Sec. 476. Annuities to survivors of Tax Court judges.
Sec. 477. Proceedings which may be assigned to commissioners.
Sec. 478. Special trial judges.
Sec. 479. Publicity of Tax Court proceedings.
Sec. 480. Elimination of mandatory retirement age for Tax Court judges.

Subtitle H—Simplification of Income Tax Credits

Sec. 481. Short title.
Sec. 482. Credits grouped together in more logical order.
Sec. 483. Uniform limitation on personal nonrefundable credits.
Sec. 484. Uniform carryover provisions for business-related credits.
Sec. 485. Technical and conforming amendments.
Sec. 486. Effective dates.

Subtitle I—Miscellaneous Simplification Provisions

Sec. 491. Rollover of certain partial distributions permitted.
Sec. 492. Preferred stock eligible under section 1244.
Sec. 493. Medical care deduction allowed for lodging away from home in certain cases.
Sec. 494. Study of simplified tax on gross income.

Subtitle J—Repeal of Certain Obsolete Provisions

Sec. 497. Termination of rules relating to qualified bond purchase plans and retirement bonds with respect to bonds issued after December 31, 1983.
Sec. 498. Repeal of rules relating to gains from disposition of property used in farming where farm losses offset nonfarm income.

Subtitle A—Revision and Simplification of Estimated Income Tax for Individuals

SEC. 411. REVISION OF PENALTY FOR FAILURE TO PAY ESTIMATED INCOME TAX.

Section 6654 (relating to addition to the tax for failure by individual to pay estimated income tax) is amended to read as follows:

"SEC. 6654. FAILURE BY INDIVIDUAL TO PAY ESTIMATED INCOME TAX.

"(a) ADDITION TO THE TAX.—Except as otherwise provided in this section, in the case of any underpayment of estimated tax by an individual, there shall be added to the tax under chapter 1 and the tax under chapter 2 for the taxable year an amount determined by applying—

"(1) the applicable annual rate established under section 6621,

"(2) to the amount of the underpayment,

"(3) for the period of the underpayment.

"(b) AMOUNT OF UNDERPAYMENT; PERIOD OF UNDERPAYMENT.—For purposes of subsection (a)—

"(1) AMOUNT.—The amount of the underpayment shall be the excess of—

"(A) the required installment, over

"(B) the amount (if any) of the installment paid on or before the due date for the installment.

"(2) PERIOD OF UNDERPAYMENT.—The period of the underpayment shall run from the due date for the installment to whichever of the following dates is the earlier—

"(A) the 15th day of the 4th month following the close of the taxable year, or

"(B) with respect to any portion of the underpayment, the date on which such portion is paid.

"(3) ORDER OF CREDITING PAYMENTS.—For purposes of paragraph (2)(B), a payment of estimated tax shall be credited against unpaid required installments in the order in which such installments are required to be paid.

"(c) NUMBER OF REQUIRED INSTALLMENTS; DUE DATES.—For purposes of this section—

"(1) PAYABLE IN 4 INSTALLMENTS.—There shall be 4 required installments for each taxable year.

"(2) TIME FOR PAYMENT OF INSTALLMENTS.—

"In the case of the following required installments:	The due date is:
1st	April 15
2nd	June 15
3rd	September 15
4th	January 15 of the following taxable year.

"(d) AMOUNT OF REQUIRED INSTALLMENTS.—For purposes of this section—

"(1) AMOUNT.—

"(A) IN GENERAL.—Except as provided in paragraph (2), the amount of any required installment shall be 25 percent of the required annual payment.

"(B) REQUIRED ANNUAL PAYMENT.—For purposes of subparagraph (A), the term 'required annual payment' means the lesser of—

"(i) 80 percent of the tax shown on the return for the taxable year (or, if no return is filed, 80 percent of the tax for such year), or

"(ii) 100 percent of the tax shown on the return of the individual for the preceding taxable year.

Clause (ii) shall not apply if the preceding taxable year was not a taxable year of 12 months or if the individual did not file a return for such preceding taxable year.

"(2) LOWER REQUIRED INSTALLMENT WHERE ANNUALIZED INCOME INSTALLMENT IS LESS THAN AMOUNT DETERMINED UNDER PARAGRAPH (1).—

"(A) IN GENERAL.—In the case of any required installment, if the individual establishes that the annualized income installment is less than the amount determined under paragraph (1)—

"(i) the amount of such required installment shall be the annualized income installment, and

"(ii) any reduction in a required installment resulting from the application of this subparagraph shall be recaptured by increasing the amount of the next required installment determined under paragraph (1) by the amount of such reduction (and by increasing subsequent required installments to the extent that the reduction has not previously been recaptured under this clause).

"(B) DETERMINATION OF ANNUALIZED INCOME INSTALLMENT.—In the case of any required installment, the annualized income installment is the excess (if any) of—

"(i) an amount equal to the applicable percentage of the tax for the taxable year computed by placing on an annualized basis the taxable income, alternative minimum taxable income, and adjusted self-employment income for months in the taxable year ending before the due date for the installment, over "(ii) the aggregate amount of any prior required installments for the taxable year.

"(C) SPECIAL RULES.—For purposes of this paragraph—

"(i) ANNUALIZATION.—The taxable income, alternative minimum taxable income, and adjusted self-employment income shall be placed on an annualized basis under regulations prescribed by the Secretary.

"(ii) APPLICABLE PERCENTAGE.—

"In the case of the following required installments:	The applicable percentage is:
1st	20
2nd	40
3rd	60
4th	80

"(iii) ADJUSTED SELF-EMPLOYMENT INCOME.—The term 'adjusted self-employment income' means self-employment income (as defined in section 1402(b)); except that section 1402(b) shall be applied by placing wages (within the meaning of section 1402(b)) for months in the taxable year ending before the due date for the installment on an annualized basis consistent with clause (i).

"(e) EXCEPTIONS.—

"(1) WHERE TAX IS SMALL AMOUNT.—No addition to tax shall be imposed under subsection (a) for any taxable year if the tax shown on the return for such taxable year (or, if no return is filed, the tax), reduced by the credit allowable under section 31, is less than $500.

"(2) WHERE NO TAX LIABILITY FOR PRECEDING TAXABLE YEAR.—No addition to tax shall be imposed under subsection (a) for any taxable year if—

"(A) the preceding taxable year was a taxable year of 12 months,

"(B) the individual did not have any liability for tax for the preceding taxable year, and

"(C) the individual was a citizen or resident of the United States throughout the preceding taxable year.

"(3) WAIVER IN CERTAIN CASES.—No addition to tax shall be imposed under subsection (a) with respect to any underpayment to the extent the Secretary determines that by reason of casualty, disaster, or other unusual circumstances the imposition of such addition to tax would be against equity and good conscience.

"(f) Tax Computed After Application of Credits Against Tax.—For purposes of this section, the term 'tax' means—

"(1) the tax imposed by chapter 1, plus

"(2) the tax imposed by chapter 2, minus

"(3) the sum of—

"(A) the credits against tax allowed by part IV of subchapter A of chapter 1, other than the credit against tax provided by section 31 (relating to tax withheld on wages), plus

"(B) to the extent allowed under regulations prescribed by the Secretary, any overpayment of the tax imposed by section 4986 (determined without regard to section 4995(a)(4)(B)).

"(g) Application of Section in Case of Tax Withheld on Wages.—

"(1) In general.—For purposes of applying this section, the amount of the credit allowed under section 31 for the taxable year shall be deemed a payment of estimated tax, and an equal part of such amount shall be deemed paid on each due date for such taxable year, unless the taxpayer establishes the dates on which all amounts were actually withheld, in which case the amounts so withheld shall be deemed payments of estimated tax on the dates on which such amounts were actually withheld.

"(2) SEPARATE APPLICATION.—The taxpayer may apply paragraph (1) separately with respect to—

"(A) wage withholding, and

"(B) all other amounts withheld for which credit is allowed under section 31.

"(h) SPECIAL RULE WHERE RETURN FILED ON OR BEFORE JANUARY 31.—If, on or before January 31 of the following taxable year, the taxpayer files a return for the taxable year and pays in full the amount computed on the return as payable, then no addition to tax shall be imposed under subsection (a) with respect to any underpayment of the 4th required installment for the taxable year.

"(i) SPECIAL RULES FOR FARMERS AND FISHERMEN.—For purposes of this section—

"(1) IN GENERAL.—If an individual is a farmer or fisherman for any taxable year—

"(A) there shall be only 1 required installment for the taxable year,

"(B) the due date for such installment shall be January 15 of the following taxable year,

"(C) the amount of such installment shall be equal to the required annual payment (determined under subsection (d)(1)(B) by substituting '66⅔ percent' for '80 percent', and

"(D) subsection (h) shall be applied—

"(i) by substituting 'March 1' for 'January 31', and

"(ii) by treating the required installment described in subparagraph (A) of this paragraph as the 4th required installment.

"(2) FARMER OR FISHERMAN DEFINED.—An individual is a farmer or fisherman for any taxable year if—

"(A) the individual's gross income from farming or fishing (including oyster farming) for the taxable year is at least 66⅔ percent of the total gross income from all sources for the taxable year, or

"(B) such individual's gross income from farming or fishing (including oyster farming) shown on the return of the individual for the preceding taxable year is at least 66⅔ percent of the total gross income from all sources shown on such return.

"(j) FISCAL YEARS AND SHORT YEARS.—

"(1) FISCAL YEARS.—In applying this section to a taxable year beginning on any date other than January 1, there shall be substituted, for the months specified in this section, the months which correspond thereto.

"(2) SHORT TAXABLE YEAR.—This section shall be applied to taxable years of less than 12 months in accordance with regulations prescribed by the Secretary.

"(k) ESTATES AND TRUSTS.—This section shall not apply to any estate or trust.

"(l) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section."

SEC. 412. REPEAL OF REQUIREMENT OF DECLARATIONS, ETC.

(a) GENERAL RULE.—The following provisions are hereby repealed:

(1) Section 6015 (relating to declaration of estimated income tax by individuals).

(2) Section 6073 (relating to time for filing declarations of estimated income tax by individuals).

(3) Section 6153 (relating to installment payments of estimated income tax by individuals).

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Subsection (g) of section 871 is amended by striking out paragraph (6) and by redesignating para-

graphs (7) and (8) as paragraphs (6) and (7), respectively.

(2) Subsection (b) of section 1403 is amended by striking out paragraph (3).

(3) Paragraph (2) of section 6012(b) is amended by striking out "or section 6015(a)".

(4) Paragraph (1) of section 6020(b) is amended by striking out "(other than a declaration of estimated tax required under section 6015)".

(5) Paragraph (1) of section 6201(b) is amended to read as follows:

"(1) ESTIMATED INCOME TAX.—No unpaid amount of estimated income tax required to be paid under section 6154 or 6654 shall be assessed."

(6) Paragraph (5) of section 6362(e) is amended by striking out "and section 6015 and other provisions relating to declarations of estimated income" and inserting in lieu thereof "and provisions relating to estimated income tax".

(7) Subsection (h) of section 6601 is amended to read as follows:

"(h) EXCEPTION AS TO ESTIMATED TAX.—This section shall not apply to any failure to pay any estimated tax required to be paid by section 6154 or 6654."

(8) Subsection (d) of section 6651 is amended to read as follows:

"(d) EXCEPTION FOR ESTIMATED TAX.—This section shall not apply to any failure to pay any estimated tax required to be paid by section 6154 or 6654."

(9) Section 7203 is amended by striking out "(other than a return required under the authority of section 6015)".

(10) Subsection (a) of section 7216 is amended—

(A) by striking out "or declarations or amended declarations of estimated tax under section 6015,", and

(B) by striking out "return or declaration" each place it appears and inserting in lieu thereof "return".

(11) Paragraph (34) of section 7701(a) is hereby repealed.

(c) CLERICAL AMENDMENTS.—

(1) The table of sections for subpart B of part II of subchapter A of chapter 61 is amended by striking out the item relating to section 6015.

(2) The table of sections for part V of subchapter A of chapter 61 is amended by striking out the item relating to section 6073.

(3) The table of sections for subchapter A of chapter 62 is amended by striking out the item relating to section 6153.

SEC. 413. CREDITING OF INCOME TAX OVERPAYMENT AGAINST ESTIMATED TAX LIABILITY.

The application of the Internal Revenue Code of 1954 with respect to the crediting of a prior year overpayment of income tax against the estimated tax shall be determined—

(1) without regard to Revenue Ruling 83–111 (and without regard to any other regulation, ruling, or decision reaching the same result as, or a result similar to, the result set forth in such Revenue Ruling); and

(2) with full regard to the rules (including Revenue Ruling 77–475) before Revenue Ruling 83–111.

SEC. 414. EFFECTIVE DATES.

(a) SECTIONS 411 AND 412.—The amendments made by sections 411 and 412 shall apply with respect to taxable years beginning after December 31, 1984.

(b) SECTION 413.—The provisions of section 413 shall take effect on January 1, 1984.

Subtitle B—Domestic Relations

SEC. 421. SHORT TITLE.

This subtitle may be cited as the "Domestic Relations Tax Reform Act of 1984".

SEC. 422. TREATMENT OF TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE.

(a) GENERAL RULE.—Part III of subchapter O of chapter 1 (relating to common nontaxable exchanges) is amended by adding at the end thereof the following new section:

"SEC. 1041. TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE.

"(a) GENERAL RULE.—No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)—

"(1) a spouse, or

"(2) a former spouse, but only if the transfer is incident to the divorce.

"(b) TRANSFER TREATED AS GIFT; TRANSFEREE HAS TRANSFEROR'S BASIS.—In the case of any transfer of property described in subsection (a)—

"(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

"(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

"(c) INCIDENT TO DIVORCE.—For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer—

"(1) occurs within 1 year after the date on which the marriage ceases, or

"(2) is related to the cessation of the marriage."

(b) TECHNICAL AMENDMENTS.—

(1) REPEAL OF SECTION 72(k).—Subsection (k) of section 72 (relating to payments in discharge of alimony) is hereby repealed.

(2) REPEAL OF SECTION 101(e).—Subsection (e) of section 101 (relating to alimony, etc., payments) is hereby repealed.

(3) COORDINATION WITH SECTION 453B.—Section 453B (relating to gain or loss on disposition of installment obligations) is amended by adding at the end thereof the following new subsection:

"(g) TRANSFERS BETWEEN SPOUSES OR INCIDENT TO DIVORCE.—In the case of any transfer described in subsection (a) of section 1041—

"(1) subsection (a) of this section shall not apply, and

"(2) the same tax treatment with respect to the transferred installment obligation shall apply to the transferee as would have applied to the transferor."

(4) TERM INTERESTS.—Paragraph (1) of section 1001(e) (relating to certain term interest) is amended

by striking out "section 1014 or 1015" and inserting in lieu thereof "section 1014, 1015, or 1041".

(5) COORDINATION WITH SECTION 1015.—Section 1015 (relating to basis of property acquired by gifts and transfers in trust) is amended by adding at the end thereof the following new subsection:

"(e) GIFTS BETWEEN SPOUSES.—In the case of any property acquired by gift in a transfer described in section 1041(a), the basis of such property in the hands of the transferee shall be determined under section 1041(b)(2) and not this section."

(6) COORDINATION WITH SECTION 1239.—

(A) Subsection (b) of section 1239, as amended by this Act, is amended by striking out paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

(B) Subparagraph (C) of section 453(h)(1) (relating to special rule where obligor and shareholder are related persons) is amended by striking out "the obligor of any installment obligation and the shareholder are related persons" and inserting in lieu thereof "the obligor of any installment obligation and the shareholder are married to each other or are related persons".

(C) The subsection heading for section 453(g) is amended by striking out "SPOUSE OR".

(7) COORDINATION WITH SECTION 47.—Section 47 (relating to certain dispositions, etc., of section 38 property) is amended by adding at the end thereof the following new subsection:

"(e) TRANSFERS BETWEEN SPOUSES OR INCIDENT TO DIVORCE.—In the case of any transfer described in subsection (a) of section 1041—

"(1) subsection (a) of this section shall not apply, and

"(2) the same tax treatment under this section with respect to the transferred property shall apply to the transferee as would have applied to the transferor."

(c) CLERICAL AMENDMENT.—The table of sections for such part III is amended by adding at the end thereof the following:

"Sec. 1041. Transfers of property between spouses or incident to divorce."

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to transfers after the date of the enactment of this Act in taxable years ending after such date.

(2) Election to have amendments apply to transfers after 1983.—If both spouses or former spouses make an election under this paragraph, the amendments made by this section shall apply to all transfers made by such spouses (or former spouses) after December 31, 1983.

(3) Exception for transfers pursuant to existing decrees.—Except in the case of an election under paragraph (2), the amendments made by this section shall not apply to transfers under any instrument in effect on or before the date of the enactment of this Act unless both spouses (or former spouses) elect to have such amendments apply to transfers under such section.

(4) Election.—Any election under paragraph (2) or (3) shall be made in such manner, at such time, and subject to such conditions, as the Secretary of the Treasury or his delegate may by regulations prescribe.

SEC. 423. TAX TREATMENT OF ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

(a) General Rule.—Section 71 (relating to alimony and separate maintenance payments) is amended to read as follows:

"SEC. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

"(a) GENERAL RULE.—Gross income includes amounts received as alimony or separate maintenance payments.

"(b) ALIMONY OR SEPARATE MAINTENANCE PAYMENTS DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'alimony or separate maintenance payment' means any payment in cash if—

"(A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,

"(B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,

"(C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and

"(D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

"(2) DIVORCE OR SEPARATION INSTRUMENT.—The term 'divorce or separation instrument' means—

"(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,

"(B) a written separation agreement, or

"(C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

"(c) PAYMENTS TO SUPPORT MINOR CHILDREN.—Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of minor children of the spouses. For purposes of the preceding sentence, if any payment is less than the amount specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

"(d) SPOUSE.—For purposes of this section, the term 'spouse' includes a former spouse.

"(e) EXCEPTION FOR JOINT RETURNS.—This section and section 215 shall not apply if the spouses make a joint return with each other.

"(f) RECOMPUTATION WHERE EXCESS FRONT-LOADING OF ALIMONY PAYMENTS.—

"(1) IN GENERAL.—If there are excess alimony payments—

"(A) the payor spouse shall include the amount of such excess payments in gross income for the payor spouse's taxable year beginning in the 3rd post-separation year, and

"(B) the payee spouse shall be allowed a deduction in computing adjusted gross income for the amount of such excess payments for the payee's taxable year beginning in the 3rd post-separation year.

"(2) EXCESS ALIMONY PAYMENTS.—For purposes of this subsection, the term 'excess alimony payments' means the sum of—

"(A) the excess payments for the 1st post-separation year, and

"(B) the excess payments for the 2nd post-separation year.

"(3) EXCESS PAYMENTS FOR 1ST POST-SEPARATION YEAR.—For purposes of this subsection, the amount of the excess payments for the 1st post-separation year is the excess (if any) of—

"(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 1st post-separation year, over

"(B) the sum of—

"(i) the average of—

"(I) the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, reduced by the excess payments for the 2nd post-separation year, and

"(II) the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

"(ii) $15,000.

"(4) EXCESS PAYMENTS FOR 2ND POST-SEPARATION YEAR.—For purposes of this subsection, the amount of the excess payments for the 2nd post-separation year is the excess (if any) of—

"(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, over

"(B) the sum of—

"(i) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

"(ii) $15,000.

"(5) EXCEPTIONS.—

"(A) WHERE PAYMENT CEASES BY REASON OF DEATH OR REMARRIAGE.—Paragraph (1) shall not apply if—

(i) either spouse dies before the close of the 3rd post-separation year, or the payee spouse remarries before the close of the 3rd post-separation year, and

(ii) the alimony or separate maintenance payments cease by reason of such death or remarriage.

"(B) SUPPORT PAYMENTS.—For purposes of this subsection, the term 'alimony or separate maintenance payment' shall not include any payment received under a decree described in subsection (b)(2)(C).

"(C) FLUCTUATING PAYMENTS NOT WITHIN CONTROL OF PAYOR SPOUSE.—For purposes of this subsection, the term 'alimony or separate maintenance payment' shall not include any payment to the extent it is made pursuant to a continuing liability (over a period of not less than 3 years) to pay a fixed portion of the income from a business or property or from compensation for employment or self-employment.

"(6) POST-SEPARATION YEARS.—For purposes of this subsection, the term '1st post-separation year' means the 1st calendar year in which the payor spouse paid to the payee spouse alimony or separate maintenance payments to which this section applies. The 2nd and 3rd post-separation years shall be the 1st and 2nd succeeding calendar years, respectively."

(b) AMENDMENT OF SECTION 215.—Section 215 (relating to deduction for alimony, etc., payments) is amended to read as follows:

"SEC. 215. ALIMONY, ETC., PAYMENTS.

"(a) GENERAL RULE.—In the case of an individual, there shall be allowed as a deduction an amount equal to the alimony or separate maintenance payments paid during such individual's taxable year.

"(b) ALIMONY OR SEPARATE MAINTENANCE PAYMENTS DEFINED.—For purposes of this section, the term 'alimony or separate maintenance payment' means any alimony or separate maintenance payment (as defined in section

71(b)) which is includible in the gross income of the recipient under section 71.

"(c) REQUIREMENT OF IDENTIFICATION NUMBER.—The Secretary may prescribe regulations under which—

"(1) any individual receiving alimony or separate maintenance payments is required to furnish such individual's taxpayer identification number to the individual making such payments, and

"(2) the individual making such payments is required to include such taxpayer identification number on such individual's return for the taxable year in which such payments are made.

"(d) COORDINATION WITH SECTION 682.—No deduction shall be allowed under this section with respect to any payment if, by reason of section 682 (relating to income of alimony trusts), the amount thereof is not includible in such individual's gross income."

(c) PENALTY FOR FAILURE TO SUPPLY IDENTIFYING NUMBER.—Section 6676 (relating to failure to supply identifying number) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) PENALTY FOR FAILURE TO SUPPLY IDENTIFYING NUMBER UNDER SECTION 215.—If any person who is required by regulations prescribed under section 215—

"(1) to furnish his taxpayer identification number to another person, or

"(2) to include on his return the taxpayer identification number of another person,

fails to comply with such requirement at the time prescribed by such regulations, such person shall, unless it is shown that such failure is due to reasonable cause and not to willful neglect, pay a penalty of $50 for each such failure."

(d) TECHNICAL AMENDMENTS.—

(1) Subparagraph (B) of section 219(b)(4) (relating to certain divorced individuals) is amended by striking out all that follows "gross income" and inserting in lieu thereof "under section 71 (relating to alimony and separate maintenance payments) by reason of a payment under a decree of divorce or separate maintenance or a written instrument incident to such a decree."

(2) Subsection (b) of section 682 (relating to income of an estate or trust in case of divorce, etc.) is amended—

(A) by striking out "or section 71", and

(B) by striking out the last sentence.

(3) Paragraph (17) of section 7701(a) (defining husband and wife) is amended by striking out "71,

152(b)(4), 215, and 682" and inserting in lieu thereof "152(b)(4) and 682".

(e) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply with respect to divorce or separation instruments (as defined in section 71(b)(2) of the Internal Revenue Code of 1954, as amended by this section) executed after December 31, 1984.

(2) MODIFICATIONS OF INSTRUMENTS EXECUTED BEFORE JANUARY 1, 1985.—The amendments made by this section shall also apply to any divorce or separation instrument (as so defined) executed before January 1, 1985, but modified on or after such date if the modification expressly provides that the amendments made by this section shall apply to such modification.

SEC. 424. DEPENDENCY EXEMPTION IN THE CASE OF CHILD OF DIVORCED PARENTS, ETC.

(a) GENERAL RULE.—Subsection (e) of section 152 (relating to support test in case of child of divorced parents, etc.) is amended to read as follows:

"(e) SUPPORT TEST IN CASE OF CHILD OF DIVORCED PARENTS, ETC.—

"(1) CUSTODIAL PARENT GETS EXEMPTION.—Except as otherwise provided in this subsection, if—

"(A) a child (as defined in section 151(e)(3)) receives over half of his support during the calendar year from his parents—

"(i) who are divorced or legally separated under a decree of divorce or separate maintenance,

"(ii) who are separated under a written separation agreement, or

"(iii) who live apart at all times during the last 6 months of the calendar year, and

"(B) such child is in the custody of one or both of his parents for more than one-half of the calendar year,

such child shall be treated, for purposes of subsection (a), as receiving over half of his support during the calendar year from the parent having custody for a greater portion of the calendar year (hereinafter in this subsection referred to as the 'custodial parent').

"(2) EXCEPTION WHERE CUSTODIAL PARENT RELEASES CLAIM TO EXEMPTION FOR THE YEAR.—A child of parents described in paragraph (1) shall be treated as having received over half of his support during a calendar year from the noncustodial parent if—

"(A) the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year, and

"(B) the noncustodial parent attaches such written declaration to the noncustodial parent's return for the taxable year beginning during such calendar year.

For purposes of this subsection, the term 'noncustodial parent' means the parent who is not the custodial parent.

"(3) EXCEPTION FOR MULTIPLE-SUPPORT AGREEMENT.—This subsection shall not apply in any case where over half of the support of the child is treated as having been received from a taxpayer under the provisions of subsection (c).

"(4) EXCEPTION FOR CERTAIN PRE-1985 INSTRUMENTS.—

"(A) IN GENERAL.—A child of parents described in paragraph (1) shall be treated as having received over half his support during a calendar year from the noncustodial parent if—

"(i) a qualified pre-1985 instrument between the parents applicable to the taxable year beginning in such calendar year provides that the noncustodial parent shall be entitled to any deduction allowable under section 151 for such child, and

"(ii) the noncustodial parent provides at least $600 for the support of such child during such calendar year.

For purposes of this subparagraph, amounts expended for the support of a child or children shall be treated as received from the noncustodial parent to the extent that such parent provided amounts for such support.

"(B) QUALIFIED PRE-1985 INSTRUMENT.—For purposes of this paragraph, the term 'qualified pre-1985 instrument' means any decree of divorce or separate maintenance or written agreement—

"(i) which is executed before January 1, 1985,

"(ii) which on such date contains the provision described in subparagraph (A)(i), and

"(iii) which is not modified on or after such date in a modification which expressly provides that this paragraph shall not apply to such decree or agreement.

"(5) SPECIAL RULE FOR SUPPORT RECEIVED FROM NEW SPOUSE OF PARENT.—For purposes of this subsection, in the case of the remarriage of a parent, support of a child received from the parent's spouse shall be treated as received from the parent.

"(6) CROSS REFERENCE.—

"For provision treating child as dependent of both parents for purposes of medical expense deduction, see section 213(d)(4)."

(b) TREATMENT AS DEPENDENT OF BOTH PARENTS FOR MEDICAL EXPENSE DEDUCTION.—

(1) Subsection (d) of section 213 (relating to definitions) is amended by redesignating paragraphs (4), (5), and (6) as paragraphs (5), (6), and (7), respectively, and by inserting after paragraph (3) the following new paragraph:

"(4) SPECIAL RULE IN THE CASE OF CHILD OF DIVORCED PARENTS, ETC.—Any child to whom section 152(e) applies shall be treated as a dependent of both parents for purposes of this section."

(2) Subsection (b) of section 105 is amended by adding at the end thereof the following new sentence: "Any child to whom section 152(e) applies shall be treated as a dependent of both parents for purposes of this section."

(3) Paragraph (6) of section 213(d) (as redesignated by paragraph (1)) is amended by striking out "the limitations of paragraph (4)" and inserting in lieu thereof "the limitations of paragraph (5)".

(c) TREATMENT OF CERTAIN MARRIED INDIVIDUALS LIVING APART.—

(1) Subsection (b) of section 143 (relating to certain married individuals living apart) is amended to read as follows:

"(b) CERTAIN MARRIED INDIVIDUALS LIVING APART.—For purposes of those provisions of this title which refer to this subsection, if—

"(1) an individual who is married (within the meaning of subsection (a)) and who files a separate return maintains as his home a household which constitutes for more than one-half of the taxable year the principal place of abode of a child (within the meaning of section 151(e)(3)) with respect to whom such individual is entitled to a deduction for the taxable year under section 151 (or would be so entitled but for paragraph (2) or (4) of section 152(e)),

"(2) such individual furnishes over one-half of the cost of maintaining such household during the taxable year, and

"(3) during the last 6 months of the taxable year, such individual's spouse is not a member of such household,

such individual shall not be considered as married."

(2) Subparagraph (A) of section 2(b)(1) (defining head of household) is amended—

(A) by striking out "which constitutes for such taxable year" and inserting in lieu thereof "which constitutes for more than one-half of such taxable year", and

(B) by striking out "under section 151" in clause (i) and inserting in lieu thereof "under section 151 (or would be so entitled but for paragraph (2) or (4) of section 152(e))".

(3) Paragraph (1) of section 43(c) (defining eligible individual) is amended—

(A) by inserting after "section 151(e)(3))" in subparagraph (A)(i) the following: "or would be so entitled but for paragraph (2) or (4) of section 152(e)", and

(B) by striking out "the child has the same principal place of abode as the individual" in subparagraph (B) and inserting in lieu thereof "the child has the same principal place of abode as the individual for more than one-half of the taxable year".

(4) Paragraph (5) of section 44A(f) (relating to special dependency test in case of divorced parents, etc.) is amended to read as follows:

"(5) Special dependency test in case of divorced parents, etc.—If—

"(A) paragraph (2) or (4) of section 152(e) applies to any child with respect to any calendar year, and

"(B) such child is under the age of 15 or is physically or mentally incapable of caring for himself,

in the case of any taxable year beginning in such calendar year, such child shall be treated as a qualifying individual described in subparagraph (A) or (B) of subsection (c)(1) (whichever is appropriate) with respect to the custodial parent (within the meaning of section 152(e)(1)), and shall not be treated as a qualifying individual with respect to the noncustodial parent."

(d) Effective Date.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984.

SEC. 425. INNOCENT SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.

(a) GENERAL RULE.—Subsection (e) of section 6013 (relating to spouse relieved of liability in certain cases) is amended to read as follows:

"(e) SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary, if—

"(A) a joint return has been made under this section for a taxable year,

"(B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,

"(C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and

"(D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,

then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

"(2) GROSSLY ERRONEOUS ITEMS.—For purposes of this subsection, the term 'grossly erroneous items' means, with respect to any spouse—

"(A) any item of gross income attributable to such spouse which is omitted from gross income, and

"(B) any claim of a deduction or credit by such spouse in an amount for which there is no basis in fact or law.

"(3) SUBSTANTIAL UNDERSTATEMENT.—For purposes of this subsection, the term 'substantial understatement' means any understatement (as defined in section 6661(b)(2)(A)) which exceeds $500.

"(4) SPECIAL RULE.—For purposes of paragraph (2)(A), the determination of the spouse to whom items of gross income (other than gross income from property) are attributable shall be made without regard to community property laws."

(b) TREATMENT OF COMMUNITY INCOME.—Section 66 (relating to treatment of community income where spouses live apart) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) SPOUSE RELIEVED OF LIABILITY IN CERTAIN OTHER CASES.—Under regulations prescribed by the Secretary, if—

"(1) an individual does not file a joint return for any taxable year,

"(2) such individual does not include in gross income for such taxable year an item of community income properly includible therein which, in accordance with the rules contained in section 879(a), would be treated as the income of the other spouse,

"(3) the individual establishes that he or she did not know of, and had no reason to know of, such item of community income, and

"(4) taking into account all facts and circumstances, it is inequitable to include such item of community income in such individual's gross income,

then, for purposes of this title, such items of community income shall be included in the gross income of the other spouse (and not in the gross income of the individual)."

(c) EFFECTIVE DATE.—The amendments made by subsections (a) and (b) shall apply to all taxable years to which the Internal Revenue Code of 1954 applies. Corresponding provisions shall be deemed to be included in the Internal Revenue Code of 1939 and shall apply to all taxable years to which such Code applies.

SEC. 426. TREATMENT OF CERTAIN PROPERTY SETTLEMENTS FOR PURPOSES OF ESTATE AND GIFT TAXES

(a) DEDUCTION ALLOWED AGAINST ESTATE TAX FOR TRANSFERS SATISFYING SECTION 2516.—

(1) IN GENERAL.—Subsection (b) of section 2043 (relating to transfers for insufficient consideration) is amended to read as follows:

"(b) MARITAL RIGHTS NOT TREATED AS CONSIDERATION.—

"(1) IN GENERAL.—For purposes of this chapter, a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration 'in money or money's worth'.

"(2) EXCEPTION.—For purposes of section 2053 (relating to expenses, indebtedness, and taxes), a transfer of property which satisfies the requirements of paragraph (1) of section 2516 (relating to certain property settlements) shall be considered to be made for an adequate and full consideration in money or money's worth."

(2) CROSS REFERENCE.—Subsection (e) of section 2053 (relating to deduction for expenses, indebtedness, and taxes) is amended to read as follows:

"(e) MARITAL RIGHTS.—

"For provisions treating certain relinquishments of marital rights as consideration in money or money's worth, see section 2043(b)(2)."

(b) SECTION 2516 EXTENDED TO AGREEMENTS ENTERED INTO WITHIN 1 YEAR AFTER DIVORCE.—Section 2516 (relating to certain property settlements) is amended by striking out so much of such section as precedes paragraph (1) thereof and inserting in lieu thereof the following:

"Where a husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within the 3-year period beginning on the date 1 year before such agreement is entered into (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to such agreement—".

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendments made by subsection (a) shall apply to estates of decedents dying after the date of the enactment of this Act.

(2) SUBSECTION (b).—The amendment made by subsection (b) shall apply to transfers after the date of the enactment of this Act.

SEC. 427. INCOME FROM SHELTERED WORKSHOPS NOT TAKEN INTO ACCOUNT IN DETERMINING DEPENDENCY EXEMPTION.

(a) IN GENERAL.—Subsection (e) of section 151 (relating to additional personal exemption for dependents) is amended by adding at the end thereof the following new paragraph:

"(5) CERTAIN INCOME OF HANDICAPPED DEPENDENTS NOT TAKEN INTO ACCOUNT.—

"(A) IN GENERAL.—For purposes of paragraph (1)(A), the gross income of an individual who is permanently and totally disabled shall not include income attributable to services performed by the individual at a sheltered workshop if—

"(i) the availability of medical care at such workshop is the principal reason for his presence there, and

"(ii) the income arises solely from activities at such workshop which are incident to such medical care.

"(B) SHELTERED WORKSHOP DEFINED.—For purposes of subparagraph (A), the term 'sheltered workshop' means a school—

"(i) which provides special instruction or training designed to alleviate the disability of the individual, and

"(ii) which is operated by—

"(I) an organization described in section 501(c)(3) and exempt from tax under section 501(a), or

"(II) a State, a possession of the United States, any political subdivision of any of the foregoing, the United States, or the District of Columbia.

"(C) PERMANENT AND TOTAL DISABILITY DEFINED.—An individual shall be treated as permanently and totally disabled for purposes of this paragraph if such individual would be so treated under paragraph (3) of section 37(e)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

Subtitle C—Revision of At-Risk Rules

SEC. 431. REVISION OF INVESTMENT CREDIT AT-RISK RULES.

(a) IN GENERAL.—So much of paragraph (8) of section 46(c) (relating to limitation to amount at risk) as precedes subparagraph (F) thereof is amended to read as follows:

"(8) CERTAIN NONRECOURSE FINANCING EXCLUDED FROM CREDIT BASE.—

"(A) LIMITATION.—The credit base of any property to which this paragraph applies shall be reduced by the nonqualified nonrecourse financing with respect to such property (as of the close of the taxable year in which placed in service).

"(B) PROPERTY TO WHICH PARAGRAPH APPLIES.—This paragraph applies to any property which—

"(i) is placed in service during the taxable year by a taxpayer described in section 465(a)(1), and

"(ii) is used in connection with an activity with respect to which any loss is subject to limitation under section 465.

"(C) CREDIT BASE DEFINED.—For purposes of this paragraph, the term 'credit base' means—

"(i) in the case of new section 38 property, the basis of the property, or

"(ii) in the case of used section 38 property, the cost of such property.

"(D) NONQUALIFIED NONRECOURSE FINANCING.—

"(i) IN GENERAL.—For purposes of this paragraph and paragraph (9), the term 'nonqualified nonrecourse financing' means any nonrecourse financing which is not qualified commercial financing.

"(ii) QUALIFIED COMMERCIAL FINANCING.—For purposes of this paragraph, the term 'qualified commercial financing' means any financing with respect to any property if—

"(I) such property is acquired by the taxpayer from a person who is not a related person,

"(II) the amount of the nonrecourse financing with respect to such property does not exceed 80 percent of the credit base of such property, and

"(III) such financing is borrowed from a qualified person or represents a loan from any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government.

Such term shall not include any convertible debt.

"(iii) NONRECOURSE FINANCING.—For purposes of this subparagraph, the term 'nonrecourse financing' includes—

"(I) any amount with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar arrangements, and

"(II) except to the extent provided in regulations, any amount borrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used or from a related person to a person (other than the taxpayer) having such an interest.

In the case of amounts borrowed by a corporation from a shareholder, subclause (II) shall not apply to an interest as a shareholder.

"(iv) QUALIFIED PERSON.—For purposes of this paragraph, the term 'qualified person' means any person which is actively and regularly engaged in the business of lending money and which is not—

"(I) a related person with respect to the taxpayer,

"(II) a person from which the taxpayer acquired the property (or a related person to such person), or

"(III) a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).

"(v) RELATED PERSON.—For purposes of clause (i), the term 'related person' has the meaning given such term by section 168(e)(4). Except as otherwise provided in regulations prescribed by the Secretary, the determination of whether a person is a related person shall be made as of the close of the taxable year in which the property is placed in service.

"(E) APPLICATION TO PARTNERSHIPS AND S CORPORATIONS.—For purposes of this paragraph and paragraph (9)—

"(i) IN GENERAL.—Except as otherwise provided in this subparagraph, in the case of any partnership or S corporation, the determination of whether a partner's or shareholder's allocable share of any financing is nonqualified nonrecourse financing shall be made at the partner or shareholder level.

"(ii) SPECIAL RULE FOR CERTAIN RECOURSE FINANCING OF S CORPORATION.—A shareholder of an S corporation shall be treated as liable for his allocable share of any financing provided by a qualified person to such corporation if—

"(I) such financing is recourse financing (determined at the corporate level), and

"(II) such financing is provided with respect to qualified business property of such corporation.

"(iii) QUALIFIED BUSINESS PROPERTY.—For purposes of clause (ii), the term 'qualified business property' means any property if—

"(I) such property is used by the corporation in the active conduct of a trade or business,

"(II) during the entire 12-month period ending on the last day of the taxable year, such corporation had at least 3 full-time employees who were not owner-employees (as defined in section 465(c)(7)(E)(i)) and substantially all the services of whom were services directly related to such trade or business, and

"(III) during the entire 12-month period ending on the last day of such taxable year, such corporation had at least 1 full-time employee substantially all of the services of whom were in the active management of the trade or business.

Such term shall not include any master sound recording or other tangible or intangible asset associated with literary, artistic, or musical properties.

"(iv) DETERMINATION OF ALLOCABLE SHARE.—The determination of any partner's or shareholder's allocable share of any financing shall be made in the same manner as the credit allowable by section 38 with respect to such property."

(b) TREATMENT OF SUBSEQUENT INCREASES AND DECREASES IN NONQUALIFIED NONRECOURSE FINANCING.—

(1) SUBSEQUENT DECREASES.—Paragraph (9) of section 46(c) (relating to subsequent increases in the taxpayer's amount at risk with respect to the property) is amended to read as follows:

"(9) SUBSEQUENT DECREASES IN NONQUALIFIED NONRECOURSE FINANCING WITH RESPECT TO THE PROPERTY.—

"(A) IN GENERAL.—If, at the close of a taxable year following the taxable year in which the property was placed in service, there is a net decrease in the amount of nonqualified nonrecourse financing with respect to such property, such net decrease shall be taken into account as additional qualified investment in such property in accordance with subparagraph (C).

"(B) CERTAIN TRANSACTIONS NOT TAKEN INTO ACCOUNT.—For purposes of this paragraph, nonqualified nonrecourse financing shall not be treated as decreased through the surrender or other use of property financed by nonqualified nonrecourse financing.

"(C) MANNER IN WHICH TAKEN INTO ACCOUNT.—

"(i) CREDIT DETERMINED BY REFERENCE TO TAXABLE YEAR PROPERTY PLACED IN SERVICE.—For purposes of determining the amount of credit allowable under section 38 and the amount of credit subject to the early disposition rules under section 47, any increase in a taxpayer's qualified investment in property by reason of this paragraph shall be deemed to be additional qualified investment made by the taxpayer in the year in which the property referred to in subparagraph (A) was first placed in service.

"(ii) CREDIT ALLOWED FOR YEAR OF DECREASE IN NONQUALIFIED NONRECOURSE FINANCING.—Any credit allowable under this subpart for any increase in qualified investment by reason of this paragraph shall be treated as earned during the taxable year of the decrease in the amount of nonqualified nonrecourse financing."

(2) SUBSEQUENT INCREASES.—So much of subsection (d) of section 47 (relating to property ceasing to be at risk) as precedes paragraph (3) thereof is amended to read as follows:

"(d) INCREASES IN NONQUALIFIED NONRECOURSE FINANCING.—

"(1) IN GENERAL.—If, as of the close of the taxable year, there is a net increase with respect to the taxpayer in the amount of nonqualified nonrecourse financing (within the meaning of section 46(c)(8)) with respect to any property to which section 46(c)(8) applied, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in credits allowed under section 38 for all prior taxable years which would have resulted from reducing the qualified investment taken into account with respect to such property by the amount of such net increase.

"(2) TRANSFERS OF DEBT MORE THAN 1 YEAR AFTER INITIAL BORROWING NOT TREATED AS INCREASING NONQUALIFIED NONRECOURSE FINANCING.—For purposes of paragraph (1), the amount of nonqualified nonrecourse financing (within the meaning of section 46(c)(8)(D)) with respect to the taxpayer shall not be treated as increased by reason of a transfer of (or agreement to transfer) any evidence of an indebtedness if such transfer occurs (or such agreement is entered into) more than 1 year after the date such indebtedness was incurred."

(c) CLARIFICATION OF COORDINATION OF SECTION 48(d) WITH AT-RISK RULES.—Subsection (d) of section 48 (relating to certain leased property) is amended by adding at the end thereof the following new paragraph:

"(6) COORDINATION WITH AT-RISK RULES.—

"(A) REQUIREMENT THAT LESSOR BE AT RISK.—In the case of any property which, in the hands of the lessor, is property to which section 46(c)(8) applies, the amount of the credit allowable to the lessee under section 38 with respect to such property by reason of an election under this subsection shall at no time exceed the credit which would have been allowable to the lessor with respect to such property (determined without regard to section 46(e)(3)) if—

"(i) the lessor's basis in such property were equal to the lessee acquisition amount, and

"(ii) no election had been made under this subsection.

"(B) LESSEE SUBJECT TO AT-RISK LIMITATIONS.—

"(i) IN GENERAL.—In the case of any lease where—

"(I) the lessee is a taxpayer described in section 465(a)(1),

"(II) the property is used by the lessee in connection with an activity with respect to which any loss is subject to limitation under section 465, and

"(III) the at-risk percentage is less than 30 percent (18 percent in the case of 3-year property),

any credit allowable under section 38 to the lessee by reason of an election under this subsection (hereinafter in this paragraph referred to as the 'total credit') shall be allowable only as provided in subparagraph (C).

"(ii) AT-RISK PERCENTAGE.—For purposes of this paragraph, the term 'at-risk percentage' means the percentage obtained by dividing—

"(I) the present value (as of the time the lease is entered into) of the aggregate lease at-risk payments, by

"(II) the lessee acquisition amount.

For purposes of subclause (I), the present value shall be determined by using a discount rate equal to the rate in effect under section 6621 as of the time the lease is entered into.

"(iii) LESSEE ACQUISITION AMOUNT.—For purposes of this paragraph, the term 'lessee acquisition amount' means the amount for which the lessee is treated as having acquired the property by reason of an election under this subsection.

"(iv) LEASE AT-RISK PAYMENT.—For purposes of this paragraph, the term 'lease at-risk payment' means any rental payment—

"(I) which the lessee is required to make under the lease in all events, and

"(II) with respect to which the lessee is not protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or other similar arrangements.

"(C) YEAR FOR WHICH CREDIT ALLOWABLE.—

"(i) IN GENERAL.—Except as provided in clause (ii), in any case to which subparagraph (B)(i) applies, the portion of the total credit allowable for any taxable year shall be an amount which bears the same ratio to such total credit as—

"(I) the aggregate rental payments made by the lessee under the lease during such taxable year, bears to

"(II) the lessee acquisition amount.

"(ii) REMAINING AMOUNT ALLOWABLE FOR YEAR IN WHICH AGGREGATE RENTAL PAYMENTS EXCEED 30 PERCENT OF ACQUISITION AMOUNT.—The total credit (to the extent not allowable for a preceding taxable year) shall be allowable for the first taxable year as of the close of which the aggregate rental payments made by the lessee under the lease equal or exceed 30 percent (18 percent in the case of 3-year property) of the lessee acquisition amount.

"(D) SPECIAL RULES FOR SUBPARAGRAPHS (B) AND (C).—

"(i) SUBPARAGRAPHS (B) AND (C) APPLY IN LIEU OF OTHER AT-RISK RULES.—In the case of any election under this subsection, paragraphs (8) and (9) of section 46(c) and subsection (d) of section 47 shall only apply with respect to the lessor.

"(ii) APPLICATION TO PARTNERSHIPS AND S CORPORATIONS.—For purposes of subparagraphs (B) and (C), rules similar to the rules of subparagraph (E) of section 46(c)(8) shall apply.

"(iii) SUBSEQUENT REDUCTIONS IN AT-RISK AMOUNT.—Under regulations prescribed by the Secretary, the principles of subsection (d) of section 47 shall apply for purposes of subparagraphs (B) and (C).

"(E) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this paragraph, including regulations—

"(i) providing for such adjustments as may be appropriate where expenses connected with the lease are borne by the lessor, and

"(ii) providing the extent to which contingencies in the lease will be disregarded."

(d) TECHNICAL AMENDMENTS.—

(1) Clause (i) of section 46(c)(8)(F) (relating to special rule for certain energy property) is amended to read as follows:

"(i) IN GENERAL.—Subparagraph (A) shall not apply with respect to qualified energy property."

(2) Subclause (III) of section 46(c)(8)(F)(ii) (defining qualified energy property) is amended to read as follows:

"(III) as of the close of the taxable year in which the property is placed in service, not more than 75 percent of the basis of such property is attributable to nonqualified nonrecourse financing, and".

(3) Subclause (IV) of section 46(c)(8)(F)(ii) is amended by striking out "nonrecourse financing (other than financing described in section 46(c)(8)(B)(ii))" and inserting in lieu thereof "nonqualified nonrecourse financing".

(4) Subparagraph (A) of section 47(d)(3) is amended by striking out "ceasing to be at risk" and inserting in lieu thereof "increasing the amount of nonqualified nonrecourse financing (within the meaning of section 46(c)(8))".

(5) Clause (i) of section 47(d)(3)(B) is amended by striking out "other than a loan described in section 46(c)(8)(B)(ii)".

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to property placed in service after the date of the enactment of this Act in taxable years ending after such date; except that such amendments shall not apply to any property to which the amendments made by section 211(f) of the Economic Recovery Tax Act of 1981 do not apply.

(2) AMENDMENTS MAY BE ELECTED RETROACTIVELY.—At the election of the taxpayer, the amendments made by this section shall apply as if included in the amendments made by section 211(f) of the Eco-

nomic Recovery Tax Act of 1981. Any election made under the preceding sentence shall apply to all property of the taxpayer to which the amendments made by such section 211(f) apply and shall be made at such time and in such manner as the Secretary of the Treasury or his delegate may by regulations prescribe.

SEC. 432. EXCLUSION OF ACTIVE BUSINESSES OF QUALIFIED C CORPORATIONS FROM AT-RISK RULES, ETC.

(a) EXCLUSION OF ACTIVE BUSINESSES OF QUALIFIED C CORPORATIONS FROM AT-RISK RULES.—Subsection (c) of section 465 (relating to deductions limited to amount at risk) is amended by adding at the end thereof the following new paragraph:

"(7) EXCLUSION OF ACTIVE BUSINESSES OF QUALIFIED C CORPORATIONS.—

"(A) IN GENERAL.—In the case of a taxpayer which is a qualified C corporation—

"(i) each qualifying business carried on by such taxpayer (or carried on by a partnership of which such taxpayer is a partner) shall be treated as a separate activity, and

"(ii) subsection (a) shall not apply to losses from such business.

"(B) QUALIFIED C CORPORATION.—For purposes of subparagraph (A), the term 'qualified

C corporation' means any corporation described in subparagraph (B) of subsection (a)(1) which is not—

"(i) a personal holding company (as defined in section 542(a)),

"(ii) a foreign personal holding company (as defined in section 552(a)), or

"(iii) a personal service corporation (as defined in section 269A(b) but determined by substituting '5 percent' for '10 percent' in section 269A(b)(2)).

"(C) QUALIFYING BUSINESS.—For purposes of this paragraph, the term 'qualifying business' means any business if—

"(i) during the entire 12-month period ending on the last day of the taxable year, such corporation had at least 1 full-time employee substantially all the services of whom were in the active management of such business,

"(ii) during the entire 12-month period ending on the last day of the taxable year, such corporation had at least 3 full-time, nonowner employees substantially all of the services of whom were services directly related to such business,

"(iii) the amount of the deductions which are allowable to the taxpayer solely by reason of sections 162 and 404 for the taxable year exceeds 15 percent of the gross income from such business for such year, and

"(iv) such business is not an excluded business.

"(D) SPECIAL RULES FOR APPLICATION OF SUBPARAGRAPH (C).—

"(i) PARTNERSHIPS IN WHICH TAXPAYER IS GENERAL PARTNER.—In the case of a business of a partnership, if—

"(I) the taxpayer is a general partner in the partnership, and

"(II) during the entire 12-month period ending on the last day of the partnership's taxable year, the number of full-time nonowner employees of the partnership (or of corporate partners of the partnership) substantially all the services of whom were directly related to such business equals or exceeds 3, then the taxpayer's proportionate share (determined on the basis of its profits interest) of the activities of the partnership in such business shall be treated as activities of the taxapayer.

"(ii) DEDUCTION FOR OWNER EMPLOYEE COMPENSATION NOT TAKEN INTO ACCOUNT.—For purposes of clause (iii) of subparagraph (C), there shall not be taken into account any deduction in respect of compensation for personal services rendered by any employee (other than a non-owner employee) of the taxpayer or any member of such employee's family (within the meaning of section 318(a)(1)).

"(iii) SPECIAL RULE FOR BANKS.—For purposes of clause (iii) of subparagraph (C), in the case of a bank (as defined in section 581) or a financial institution to which section 591 applies—

"(I) gross income shall be determined without regard to the exclusion of interest from gross income under section 103, and

"(II) in addition to the deductions described in such clause, there shall also be taken into account the amount of the deductions which are allowable for amounts paid or credited to the accounts of depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts under section 163 or 591.

"(iv) SPECIAL RULE FOR LIFE INSURANCE COMPANIES.—

"(I) IN GENERAL.—Clause (iii) of subparagraph (C) shall not apply to any insurance business of a qualified life insurance company.

"(II) INSURANCE BUSINESS.—For purposes of subclause (I), the term 'insurance business' means any business which is not a noninsurance business (within the meaning of section 806(c)(3)).

"(III) QUALIFIED LIFE INSURANCE COMPANY.—For purposes of subclause (I), the term 'qualified life insurance company' means any company which would be a life insurance company as defined in section 816 if unearned premiums were not taken into account under subsections (a)(2) and (c) of section 816.

"(E) DEFINITIONS.—For purposes of this paragraph—

"(i) NON-OWNER EMPLOYEE.—The term 'non-owner employee' means any employee who does not own, at any time during the taxable year, more than 5 percent in value of the outstanding stock of the taxpayer. For purposes of the preceding sentence, section 318 shall apply, except that '5 percent' shall be substituted for '50 percent' in section 318(a)(2)(C).

"(ii) EXCLUDED BUSINESS.—The term 'excluded business' means—

"(I) equipment leasing (as defined in paragraph (6)), and

"(II) any business involving the use, exploitation, sale, lease, or other disposition of master sound recordings, motion picture films, video tapes, or tangible or intangible assets associated with literary, artistic, musical, or similar properties.

"(iii) SPECIAL RULES RELATING TO COMMUNICATIONS INDUSTRY, ETC.—

"(I) BUSINESS NOT EXCLUDED WHERE TAXPAYER NOT COMPLETELY AT RISK.—A business involving the use, exploitation, sale, lease, or other disposition of property described in subclause (II) of clause (ii) shall not constitute an excluded business by reason of such subclause if the taxpayer is at risk with respect to all amounts paid or incurred (or chargeable to capital account) in such business.

"(II) CERTAIN LICENSED BUSINESSES NOT EXCLUDED.—For purposes of subclause (II) of clause (ii), the provision of radio, television, cable television, or similar services pursuant to a license or franchise granted by the Federal Communications Commission or any other Federal, State, or local authority shall not constitute an excluded business by reason of such subclause.

"(F) AFFILIATED GROUP TREATED AS 1 TAXPAYER.—For purposes of this paragraph—

"(i) IN GENERAL.—Except as provided in clause (iii), the component members of an affiliated group of corporations shall be treated as a single taxpayer.

"(ii) AFFILIATED GROUP OF CORPORATIONS.—The term 'affiliated group of corporations' means an affiliated group (as defined in section 1504(a)) which files or is required to file consolidated income tax returns.

"(iii) COMPONENT MEMBER.—The term 'component member' means an includible corporation (as defined in section 1504) which is a member of the affiliated group.

"(G) LOSS OF 1 MEMBER OF AFFILIATED GROUP MAY NOT OFFSET INCOME OF PERSONAL HOLDING COMPANY.—Nothing in this paragraph shall permit any loss of a member of an affiliated group to be used as an offset against the income of any other member of such group which is a personal holding company (as defined in section 542(a))."

(b) ACTIVITIES TREATED AS SEPARATE ACTIVITIES BY STATUTE MAY BE AGGREGATED WHERE TAXPAYER

ACTIVELY PARTICIPATES IN THE MANAGEMENT OF EACH ACTIVITY.—Paragraph (2) of section 465(c) (relating to activities to which risk applies) is amended to read as follows:

"(2) SEPARATE ACTIVITIES.—For purposes of this section—

"(A) IN GENERAL.—Except as provided in subparagraph (B), a taxpayer's activity with respect to each—

"(i) film or video tape,

"(ii) section 1245 property which is leased or held for leasing,

"(iii) farm,

"(iv) oil and gas property (as defined under section 614), or

"(v) geothermal property (as defined under section 614),

shall be treated as a separate activity.

"(B) AGGREGATION OF ACTIVITIES WHERE TAXPAYER ACTIVELY PARTICIPATES IN MANAGEMENT OF EACH ACTIVITY.—

"(i) IN GENERAL.—All activities which are described in both subparagraph (A) and clause (ii) of this subparagraph and which constitute part or all of a trade or business shall be treated as 1 activity.

"(ii) ACTIVITIES.—An activity is described in this clause if—

"(I) the taxpayer actively participates in the management of such activity, or

"(II) such activity is carried on by a partnership or an S corporation and 65 percent or more of the losses for the taxable year is allocable to persons who actively participate in the management of such activity."

(c) CORPORATIONS CONSIDERED AT RISK WITH RESPECT TO AMOUNTS BORROWED FROM SHAREHOLDERS, ETC.—Paragraph (3) of section 465(b) (relating to certain borrowed amounts excluded) is amended to read as follows:

"(3) CERTAIN BORROWED AMOUNTS EXCLUDED.—

"(A) IN GENERAL.—For purposes of paragraph (1)(B), amounts borrowed shall not be considered to be at risk with respect to an activity if such amounts are borrowed from any person who has an interest in such activity or (except to the extent provided in regulations) from a related person to a person (other than the taxpayer) having such an interest.

"(B) EXCEPTIONS.—

"(i) INTEREST AS CREDITOR.—Subparagraph (A) shall not apply to an interest as a creditor in the activity.

"(ii) INTEREST AS SHAREHOLDER WITH RESPECT TO AMOUNTS BORROWED BY CORPORATION.—In the case of amounts borrowed by a corporation from a shareholder, subparagraph (A) shall not apply to an interest as a shareholder.

"(C) RELATED PERSON DEFINED.—For purposes of subparagraph (A), the term 'related person' has the meaning given such term by section 168(e)(4)."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983; except that any loss from an activity described in section 465(c)(7)(A) of the Internal Revenue Code of 1954 (as amended by this section) which (but for the amendments made by this section) would have been treated as a deduction for the taxpayer's first taxable year beginning after December 31, 1983, under section 465(a)(2) of such Code shall be allowed as a deduction for such first taxable year notwithstanding such amendments.

Subtitle D—Estate Tax Provisions

SEC. 441. PERMANENT RULES FOR REFORMING GOVERNING INSTRUMENTS CREATING CHARITABLE REMAINDER TRUSTS AND OTHER CHARITABLE INTERESTS.

(a) GENERAL RULE.—Paragraph (3) of section 2055(e) (relating to disallowance of deductions in certain cases) is amended to read as follows:

"(3) REFORMATIONS TO COMPLY WITH PARAGRAPH (2).—

"(A) IN GENERAL.—A deduction shall be allowed under subsection (a) in respect of any qualified reformation.

"(B) QUALIFIED REFORMATION.—For purposes of this paragraph, the term 'qualified reformation' means a change of a governing instrument by reformation, amendment, construction, or otherwise which changes a reformable interest into a qualified interest but only if—

"(i) any difference between—

"(I) the actuarial value (determined as of the date of the decedent's death) of the qualified interest, and

"(II) the actuarial value (as so determined) of the reformable interest, does not exceed 5 percent of the actuarial value (as so determined) of the reformable interest,

"(ii) in the case of—

"(I) a charitable remainder interest, the nonremainder interest (before and after the qualified reformation) terminated at the same time, or

"(II) any other interest, the reformable interest and the qualified interest are for the same period, and

"(iii) such change is effective as of the date of the decedent's death.

A nonremainder interest (before reformation) for a term of years in excess of 20 years shall be treated as satisfying subclause (I) of clause (ii) if such interest (after reformation) is for a term of 20 years.

"(C) REFORMABLE INTEREST.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'reformable interest' means any interest for which a deduction would be allowable under subsection (a) at the time of the decedent's death but for paragraph (2).

"(ii) BENEFICIARY'S INTEREST MUST BE FIXED.—The term 'reformable interest' does not include any interest unless, before the remainder vests in possession, all payments to persons other than an organization described in subsection (a) are expressed either in specified dollar amounts or a fixed percentage of the fair market value of the property. For purposes of determining whether all such payments are expressed as a fixed percentage of the fair market value of the property, section 664(d)(3) shall be taken into account.

"(iii) SPECIAL RULE WHERE TIMELY COMMENCEMENT OF REFORMATION.—Clause (ii) shall not apply to any interest if a judicial proceeding is commenced to change such interest into a qualified interest not later than the 90th day after—

"(I) if an estate tax return is required to be filed, the last date (including extensions) for filing such return, or

"(II) if no estate tax return is required to be filed, the last date (including extensions) for filing the income tax return for the 1st taxable year for which such a return is required to be filed by the trust.

"(iv) SPECIAL RULE FOR WILL EXECUTED BEFORE JANUARY 1, 1979, ETC.—In the case of any interest passing under a will executed before January 1, 1979, or under a trust created before such date, clause (ii) shall not apply.

"(D) QUALIFIED INTEREST.—For purposes of this paragraph, the term 'qualified interest' means an interest for which a deduction is allowable under subsection (a).

"(E) LIMITATION.—The deduction referred to in subparagraph (A) shall not exceed the amount of the deduction which would have been allowable for the reformable interest but for paragraph (2).

"(F) SPECIAL RULE WHERE INCOME BENEFICIARY DIES.—If (by reason of the death of any individual) by the due date for filing the estate tax return (including any extension thereof) a reformable interest is in a wholly charitable trust or passes directly to a person or for a use described in subsection (a), a deduction shall be allowed for such reformable interest as if it had met the requirements of paragraph (2) on the date of the decedent's death. For purposes of the preceding sentence, the term 'wholly charitable trust' means a charitable trust which, upon the allowance of a deduction, would be described in section 4947(a)(1).

"(G) STATUTE OF LIMITATIONS.—The period for assessing any deficiency of any tax attributable to the application of this paragraph shall not expire before the date 1 year after the date on which the Secretary is notified that such reformation has occurred.

"(H) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this paragraph, including regulations providing such adjustments in the application of the provisions of section 508 (relating to special rules relating to section 501(c)(3) organizations), subchapter J (relating to estates, trusts, beneficiaries, and decedents), and chapter 42 (relating to private foundations) as may be necessary by reason of the qualified reformation.

"(I) REFORMATIONS PERMITTED IN CASE OF REMAINDER INTERESTS IN RESIDENCE OR

FARM, POOLED INCOME FUNDS, ETC.—The Secretary shall prescribe regulations (consistent with the provisions of this paragraph) permitting reformations in the case of any failure—

"(i) to meet the requirements of section 170(f)(3)(B) (relating to remainder interests in personal residence or farm, etc.), or

"(ii) to meet the requirements of section 642(c)(5)."

(b) INCOME TAX DEDUCTION.—Subsection (f) of section 170 (relating to disallowance of deduction in certain cases and special rules) is amended by adding at the end thereof the following new paragraph:

"(7) REFORMATIONS TO COMPLY WITH PARAGRAPH (2).—

"(A) IN GENERAL.—A deduction shall be allowed under subsection (a) in respect of any qualified reformation.

"(B) RULES SIMILAR TO SECTION 2055(e)(3) TO APPLY.—For purposes of this paragraph, rules similar to the rules of section 2055(e)(3) shall apply."

(c) GIFT TAX DEDUCTION.—Subsection (c) of section 2522 is amended by adding at the end thereof the following new paragraph:

"(4) Reformations to comply with paragraph (2).—

"(A) In general.—A deduction shall be allowed under subsection (a) in respect of any qualified reformation.

"(B) Rules similar to section 2055(e)(3) to apply.—For purposes of this paragraph, rules similar to the rules of section 2055(e)(3) shall apply."

(d) Treatment of Certain Contingencies Under Section 664.—Section 664 (relating to charitable remainder trusts) is amended by adding at the end thereof the following new subsection:

"(f) Certain Contingencies Permitted.—

"(1) General rule.—If a trust would, but for a qualified contingency, meet the requirements of paragraph (1)(A) or (2)(A) of subsection (d), such trust shall be treated as meeting such requirements.

"(2) Value determined without regard to qualified contingency.—For purposes of determining the amount of any charitable contribution (or the actuarial value of any interest), a qualified contingency shall not be taken into account.

"(3) Qualified contingency.—For purposes of this subsection, the term 'qualified contingency' means any provision of a trust which provides that, upon the happening of a contingency, the payments described in paragraph (1)(A) or (2)(A) of subsection (d) (as the case may be) will terminate not later than such payments would otherwise terminate under the trust."

(e) EFFECTIVE DATE.—

(1) SUBSECTIONS (a), (b), AND (c).—The amendments made by subsections (a), (b), and (c) shall apply to reformations after December 31, 1978; except that such amendments shall not apply to any reformation to which section 2055(e)(3) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) applies. For purposes of applying clause (iii) of section 2055(e)(3)(C) of such Code (as amended by this section), the 90th day described in such clause shall be treated as not occurring before the 90th day after the date of the enactment of this Act.

(2) SUBSECTION (d).—The amendment made by subsection (d) shall apply to transfers after December 31, 1978.

(3) STATUTE OF LIMITATIONS.—

(A) IN GENERAL.—If on the date of the enactment of this Act (or at any time before the date 1 year after such date of enactment), credit or refund of any overpayment of tax attributable to the amendments made by this section is barred by any law or rule of law, such credit or refund of such overpayment may nevertheless be made if claim therefor is filed before the date 1 year after the date of the enactment of this Act.

(B) NO INTEREST WHERE STATUTE CLOSED ON DATE OF ENACTMENT.—In any case where the making of the credit or refund of the overpayment described in subparagraph (A) is barred on the date of the enactment of this Act, no interest shall be allowed with respect to such overpayment (or any related adjustment) for the period before the date 180 days after the date on which the Secretary of the Treasury (or his delegate) is notified that the reformation has occurred.

SEC. 442. ALTERNATE VALUATION ELECTION AVAILABLE ONLY WHERE IT RESULTS IN REDUCTION OF GROSS ESTATE AND ESTATE TAX.

(a) GENERAL RULE.—Section 2032 (relating to alternate valuation) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) ELECTION MUST DECREASE GROSS ESTATE AND ESTATE TAX.—No election may be made under this section with respect to an estate unless such election will decrease—

"(1) the value of the gross estate, and

"(2) the amount of the tax imposed by this chapter (reduced by credits allowable against such tax)."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply with respect to estates of decedents dying after the date of the enactment of this Act.

SEC. 443. ALTERNATE VALUATION ELECTION AVAILABLE ON LATE RETURN.

(a) GENERAL RULE.—Subsection (d) of section 2032 (relating to time of election), as amended by section 442, is amended to read as follows:

"(d) ELECTION.—

"(1) IN GENERAL.—The election provided for in this section shall be made by the executor on the return of the tax imposed by this chapter. Such an election, once made, shall be irrevocable.

"(2) STATUTE OF LIMITATIONS WHERE PROPERTY SOLD BEFORE ELECTION.—If—

"(A) an election provided for in this section is made after a disposition of any property, and

"(B) the basis of such property is reduced by reason of such election,

the period for assessing any deficiency of tax attributable to such basis reduction shall not expire before the date 1 year after the date on which such election is made."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to the estates of decedents dying after the date of the enactment of this Act.

Subtitle E—Foreign Tax Provisions

SEC. 451. DEFINITION OF RESIDENT ALIEN AND NONRESIDENT ALIEN.

(a) GENERAL RULE.—Section 7701 (relating to definitions) is amended by redesignating subsections (b), (c), and (d) as subsections (c), (d), and (e), respectively, and by inserting after subsection (a) the following new subsection:

"(b) DEFINITION OF RESIDENT ALIEN AND NONRESIDENT ALIEN.—

"(1) IN GENERAL.—For purposes of this title (other than subtitle B)—

"(A) RESIDENT ALIEN.—An alien individual shall be treated as a resident of the United States with respect to any calendar year if (and only if) such individual meets the requirements of clause (i) or (ii):

"(i) LAWFULLY ADMITTED FOR PERMANENT RESIDENCE.—Such individual is a lawful permanent resident of the United

States at any time during such calendar year.

"(ii) SUBSTANTIAL PRESENCE TEST.—Such individual meets the substantial presence test of paragraph (3).

"(B) NONRESIDENT ALIEN.—An individual is a nonresident alien if such individual is neither a citizen of the United States nor a resident of the United States (within the meaning of subparagraph (A)).

"(2) SPECIAL RULES FOR FIRST AND LAST YEAR OF RESIDENCY.—

"(A) FIRST YEAR OF RESIDENCY.—

"(i) IN GENERAL.—If an alien individual is a resident of the United States under paragraph (1)(A) with respect to any calendar year, but was not a resident of the United States at any time during the preceding calendar year, such alien individual shall be treated as a resident of the United States only for the portion of such calendar year which begins on the residency starting date.

"(ii) RESIDENCY STARTING DATE FOR INDIVIDUALS LAWFULLY ADMITTED FOR PERMANENT RESIDENCE.—In the case of an individual who is a lawful permanent resident of the United States at any time during the calendar year, but does not meet the substantial presence test of paragraph (3), the residency starting date shall be the first day in such calendar year on which he was present in the United States while a lawful permanent resident of the United States.

"(iii) RESIDENCY STARTING DATE FOR INDIVIDUALS MEETING SUBSTANTIAL PRESENCE TEST.—In the case of an individual who meets the substantial presence test of paragraph (3) with respect to any calendar year, the residency starting date shall be the first day during such calendar year on which the individual is present in the United States.

"(B) LAST YEAR OF RESIDENCY.—An alien individual shall not be treated as a resident of the United States during a portion of any calendar year if—

"(i) such portion is after the last day in such calendar year on which the individual was present in the United States (or, in the case of an individual described in paragraph

(1)(A)(i), the last day on which he was so described),

"(ii) during such portion the individual has a closer connection to a foreign country than to the United States, and

"(iii) the individual is not a resident of the United States at any time during the next calendar year.

"(C) CERTAIN NOMINAL PRESENCE DISREGARDED.—

"(i) IN GENERAL.—For purposes of subparagraphs (A)(iii) and (B), an individual shall not be treated as present in the United States during any period for which the individual establishes that he has a closer connection to a foreign country than to the United States.

"(ii) NOT MORE THAN 10 DAYS DISREGARDED.—Clause (i) shall not apply to more than 10 days on which the individual is present in the United States.

"(3) SUBSTANTIAL PRESENCE TEST.—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, an individual meets the substantial presence test of this paragraph with respect to any calendar year (hereinafter in this subsection referred to as the ‘current year’) if—

“(i) such individual was present in the United States on at least 31 days during the calendar year, and

“(ii) the sum of the number of days on which such individual was present in the United States during the current year and the 2 preceding calendar years (when multiplied by the applicable multiplier determined under the following table) equals or exceeds 183 days:

“In the case of days in:	**The applicable multiplier is:**
Current year	1
1st preceding year	⅓
2nd preceding year	⅙

“(B) EXCEPTION WHERE INDIVIDUAL IS PRESENT IN THE UNITED STATES DURING LESS THAN ONE-HALF OF CURRENT YEAR AND CLOSER CONNECTION TO FOREIGN COUNTRY IS ESTABLISHED.—An individual shall not be treated as meeting the substantial presence test of this paragraph with respect to any current year if—

“(i) such individual is present in the United States on fewer than 183 days during the current year, and "(ii) it is established that for the current year such individual has a tax home (as defined in section 911(d)(3) without regard to the second sentence thereof) in a foreign country and has a closer connection to such foreign country than to the United States.

"(C) SUBPARAGRAPH (B) NOT TO APPLY IN CERTAIN CASES.—Subparagraph (B) shall not apply to any individual with respect to any current year if at any time during such year—

"(i) such individual had an application for adjustment of status pending, or

"(ii) such individual took other steps to apply for status as a lawful permanent resident of the United States.

"(D) MEDICAL CONDITION EXCEPTION FOR SUBPARAGRAPH (B)(i).—Clause (i) of subparagraph (B) shall not apply to any individual who was unable to leave the United States because of a medical condition which arose while such individual was present in the United States.

"(E) EXCEPTION FOR EXEMPT INDIVIDUALS.—An individual shall not be treated as being present in the United States on any day if such individual is an exempt individual for such day.

"(4) Exempt individual defined.—For purposes of this subsection—

"(A) In general.—An individual is an exempt individual for any day if, for such day, such individual is—

"(i) a foreign government-related individual,

"(ii) a teacher or trainee, or

"(iii) a student.

"(B) Foreign government-related individual.—The term 'foreign government-related individual' means any individual temporarily present in the United States by reason of—

"(i) diplomatic status, or a visa which the Secretary (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status for purposes of this subsection,

"(ii) being a full-time employee of an international organization, or

"(iii) being a member of the immediate family of an individual described in clause (i) or (ii).

"(C) TEACHER OR TRAINEE.—The term 'teacher or trainee' means any individual—

"(i) who is temporarily present in the United States under subparagraph (J) of section 101(15) of the Immigration and Nationality Act (other than as a student), and

"(ii) who substantially complies with the requirements for being so present.

"(D) STUDENT.—The term 'student' means any individual—

"(i) who is temporarily present in the United States—

"(I) under subparagraph (F) of section 101(15) of the Immigration and Nationality Act, or

"(II) as a student under subparagraph (J) of such section 101(15), and

"(ii) who substantially complies with the requirements for being so present.

"(E) SPECIAL RULES FOR TEACHERS, TRAINEES, AND STUDENTS.—

"(i) LIMITATION ON TEACHERS AND TRAINEES.—An individual shall not be treated as an exempt individual by reason of clause (ii) of subparagraph (A) for the current year if, for any 2 calendar years during the preceding 6 calendar years, such person was an exempt person under clause (ii) or (iii) of subparagraph (A).

"(ii) LIMITATION ON STUDENTS.—For any calendar year after the 5th calendar year for which an individual was an exempt individual under clause (ii) or (iii) of subparagraph (A), such individual shall not be treated as an exempt individual by reason of clause (iii) of subparagraph (A), unless such individual establishes to the satisfaction of the Secretary that such individual does not intend to permanently reside in the United States and that such individual meets the requirements of subparagraph (D)(ii).

"(5) LAWFUL PERMANENT RESIDENT.—For purposes of this subsection, an individual is a lawful permanent resident of the United States at any time if—

"(A) such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and

"(B) such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).

"(6) PRESENCE IN THE UNITED STATES.—For purposes of this subsection—

"(A) IN GENERAL.—Except as provided in subparagraph (B), an individual shall be treated as present in the United States on any day if such individual is physically present in the United States at any time during such day.

"(B) COMMUTERS FROM CANADA OR MEXICO.—If an individual regularly commutes to employment (or self-employment) in the United States from a place of residence in Canada or Mexico, such individual shall not be treated as present in the United States on any day during which he so commutes.

"(7) ANNUAL STATEMENTS.—The Secretary may prescribe regulations under which an individual who (but for subparagraph (B), (D), or (E) of paragraph (3)) would meet the substantial presence test of paragraph (3) is required to submit an annual statement setting forth the basis on which such individual claims the benefits of subparagraph (B), (D), or (E) of paragraph (3), as the case may be.

"(8) TAXABLE YEAR.—

"(A) IN GENERAL.—For purposes of this title, an alien individual who has not established a taxable year for any prior period shall be treated as having a taxable year which is the calendar year.

"(B) FISCAL YEAR TAXPAYER.—If—

"(i) an individual is treated under paragraph (1) as a resident of the United States for any calendar year, and

"(ii) after the application of subparagraph (A), such individual has a taxable year other than a calendar year,

he shall be treated as a resident of the United States with respect to any portion of a taxable year which is within such calendar year."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1984.

(2) TRANSITIONAL RULE FOR APPLYING SUBSTANTIAL PRESENCE TEST.—

(A) If an alien individual was not a resident of the United States as of the close of calendar year 1984, the determination of whether such individual meets the substantial presence test of section 7701(b)(3) of the Internal Revenue Code of 1954 (as added by this section) shall be made by only taking into account presence after 1984.

(B) If an alien individual was a resident of the United States as of the close of calendar year 1984, but was not a resident of the United States as of the close of calendar year 1983, the determination of whether such individual meets such substantial presence test shall be made by only taking into account presence in the United States after 1983.

(3) TRANSITIONAL RULE FOR APPLYING LAWFUL RESIDENCE TEST.—In the case of any individual who—

(A) was a lawful permanent resident of the United States (within the meaning of section 7701(b)(5) of the Internal Revenue Code of 1954, as added by this section) as of the close of calendar year 1983, and

(B) was present in the United States on any day during 1984,

for purposes of section 7701(b)(2)(A) of such Code (as so added), such individual shall be treated as a resident of the United States during 1984.

SEC. 452. TREATMENT OF COMMUNITY INCOME.

(a) GENERAL RULE.—Subsection ([illegible]) of section 879 (relating to tax treatment of certain community income in the case of a resident or citizen of the United States who is married to a nonresident alien individual) is amended by striking out so much of such subsection as precedes paragraph (1) thereof and inserting in lieu thereof the following:

"(a) GENERAL RULE.—In the case of a married couple 1 or both of whom are nonresident alien individuals and who have community income for the taxable year, such community income shall be treated as follows:".

(b) CLERICAL AMENDMENTS.—

(1) The heading of section 879 is amended to read as follows:

"SEC. 879. TAX TREATMENT OF CERTAIN COMMUNITY INCOME IN THE CASE OF NONRESIDENT ALIEN INDIVIDUALS."

(2) The table of sections for subpart A of part II of subchapter N of chapter 1 is amended by striking out the item relating to section 879 and inserting in lieu thereof the following:

"Sec. 879. Tax treatment of certain community income in the case of nonresident alien individuals."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1984.

SEC. 453. AMENDMENTS RELATED TO FOREIGN PERSONAL HOLDING COMPANIES.

(a) ATTRIBUTION FROM FAMILY MEMBERS.—Subsection (a) of section 554 (relating to constructive ownership) is amended by adding at the end thereof the following new sentence:

"For purposes of the stock ownership requirement provided in section 552(a)(2), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered by reason of so much of paragraph (2) as relates to attribution through family membership as owned by a citizen or by a resident alien individual who is not the spouse of the nonresident individual."

(b) INCLUSION IN INCOME OF UNITED STATES PERSONS HOLDING INTEREST THROUGH FOREIGN ENTITY.—Section 551 (relating to foreign personal holding company income taxed to United States shareholders) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) STOCK HELD THROUGH FOREIGN ENTITY.—For purposes of this section, stock of a foreign personal holding company owned (directly or through the application of this subsection) by—

"(1) a partnership, estate, or trust which is not a United States shareholder, or

"(2) a foreign corporation which is not a foreign personal holding company,

shall be considered as being owned proportionately by its partners, beneficiaries, or shareholders. In any case to which the preceding sentence applies, the Secretary may by regulations provide for such adjustments in the application of this part as may be necessary to carry out the purposes of the preceding sentence."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 1983.

(2) 1-YEAR EXTENSION FOR CERTAIN TRUSTS CREATED BEFORE JUNE 30, 1953.—

(A) IN GENERAL.—The amendment made by subsection (b) shall apply to taxable years of a foreign corporation beginning after December 31, 1984, with respect to stock of such corporation which is held (directly or indirectly, within the meaning of section 554 of the Internal Revenue Code of 1954) by a trust created before June 30, 1953, if—

(i) none of the beneficiaries of such trust was a citizen or resident of the United States at the time of its creation or within 10 years thereafter, and

(ii) such trust does not, after July 1, 1983, acquire (directly or indirectly) stock of any foreign personal holding company other than a company described in subparagraph (B).

(B) DESCRIPTION OF COMPANY.—A company is described in this subparagraph if—

(i) substantially all of the assets of such company are stock or assets previously held by such trust, or

(ii) such company ceases to be a foreign personal holding company before January 1, 1985.

SEC. 454. AMENDMENTS RELATED TO SECTION 1248.

(a) ELIMINATION OF DOUBLE TAXATION OF EARNINGS AND PROFITS OF CERTAIN FOREIGN CORPORATIONS.—

(1) Section 959 (relating to exclusion from gross income of previously taxed earnings and profits) is amended by adding at the end thereof the following new subsection:

"(e) COORDINATION WITH AMOUNTS PREVIOUSLY TAXED UNDER SECTION 1248.—For purposes of this section and section 960(b), any amount included in the gross income of any person as a dividend by reason of subsection (a) or (f) of section 1248 shall be treated as an amount included in the gross income of such person under section 951(a)(1)(A)."

(2) Section 1248 is amended by adding at the end thereof the following new subsection:

"(i) CROSS REFERENCE.—

"For provision excluding amounts previously taxed under this section from gross income when subsequently distributed, see section 959(e)."

(b) CLARIFICATION OF SECTION 1248(c)(2)(D).—Subparagraph (D) of section 1248(c)(2) (relating to earnings and profits of subsidiaries of foreign corporations) is amended by striking out "section 958(a)(2)" and inserting in lieu thereof "section 958(a)".

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply with respect to transactions to which subsection (a) or (f) of section 1248 of the Internal Revenue Code of 1954 applies occurring after the date of the enactment of this Act.

(2) ELECTION OF EARLIER DATE FOR CERTAIN TRANSACTIONS.—

(A) IN GENERAL.—If the appropriate election is made under subparagraph (B), the amendments made by subsection (a) shall apply with respect to transactions to which subsection (a) or (f) of section 1248 of such Code applies occurring after October 9, 1975.

(B) ELECTION.—

(i) Subparagraph (A) shall apply with respect to transactions to which subsection (a) of section 1248 of such Code applies if the foreign corporation described in such subsection (or its successor in interest) so elects.

(ii) Subparagraph (A) shall apply with respect to transactions to which subsection (f) of section 1248 of such Code applies if the domestic corporation described in section 1248(f)(1) of such Code (or its successor) so elects.

(iii) Any election under clause (i) or (ii) shall be made not later than 180 days after the date of the enactment of this Act and shall be made in such manner as the Secretary of the Treasury or his delegate shall prescribe.

SEC 455. COORDINATION OF SUBPART F WITH FOREIGN PERSONAL HOLDING COMPANY PROVISIONS.

(a) GENERAL RULE.—Subsection (d) of section 951 (relating to coordination with foreign personal holding company provisions) is amended to read as follows:

"(d) COORDINATION WITH FOREIGN PERSONAL HOLDING COMPANY PROVISIONS.—If, but for this subsection, an amount would be included in the gross income of a United States shareholder for any taxable year both under subsection (a)(1)(A)(i) and under section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholder), such amount shall be included in the gross income of such shareholder only under subsection (a)(1)(A)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years of United States shareholders beginning after the date of the enactment of this Act.

SEC. 456. STAPLED STOCK; STAPLED ENTITIES.

(a) GENERAL RULE.—Part IX of subchapter B of chapter 1 is amended by inserting after section 269A the following new section:

"SEC 269B. STAPLED ENTITIES.

"(a) GENERAL RULE.—Except as otherwise provided by regulations, for purposes of this title—

"(1) if a domestic corporation and a foreign corporation are stapled entities, the foreign corporation shall be treated as a domestic corporation.

"(2) in applying section 1563, stock in a second corporation which constitutes a stapled interest with respect to stock of a first corporation shall be treated as owned by such first corporation, and

"(3) in applying subchapter M for purposes of determining whether any stapled entity is a regulated investment company or a real estate investment trust, all entities which are stapled entities with respect to each other shall be treated as 1 entity.

"(b) SECRETARY TO PRESCRIBE REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities. Such regulations may include (but shall not be limited to) regulations providing the extent to which 1 of such entities shall be treated as owning the other entity (to the extent of the stapled interest).

"(c) DEFINITIONS.—For purposes of this section—

"(1) ENTITY.—The term 'entity' means any corporation, partnership, trust, association, estate, or other form of carrying on a business or activity.

"(2) STAPLED ENTITIES.—The term 'stapled entities' means any group of 2 or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of stapled interests.

"(3) STAPLED INTERESTS.—Two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of 1 of such interests the other such interests are also transferred or required to be transferred.

"(d) SPECIAL RULE FOR TREATIES.—Nothing in section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section."

(b) CLERICAL AMENDMENT.—The table of sections for part IX of subchapter B of chapter 1 is amended by inserting after the item relating to section 269A the following new item:

"Sec. 269B. Stapled entities."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall take effect on the date of the enactment of this Act.

(2) INTERESTS STAPLED AS OF JUNE 30, 1983.—Except as otherwise provided in this subsection, in the case of any interests which on June 30,

1983, were stapled interests (as defined in section 269B(c)(3) of the Internal Revenue Code of 1954 (as added by this section), the amendments made by this section shall take effect on January 1, 1985 (January 1, 1987 in the case of a foreign corporation).

(3) CERTAIN STAPLED ENTITIES WHICH INCLUDE REAL ESTATE INVESTMENT TRUST.—Paragraph (3) of section 269B(a) of such Code shall not apply in determining the application of the provisions of part II of subchapter M of chapter 1 of such Code to any real estate investment trust which is part of a group of stapled entities if—

(A) all members of such group were stapled entities as of June 30, 1983, and

(B) as of June 30, 1983, such group included one or more real estate investment trusts.

(4) CERTAIN STAPLED ENTITIES WHICH INCLUDE PUERTO RICAN CORPORATIONS.—

(A) Paragraph (1) of section 269B(a) of such Code shall not apply to a domestic corporation and a qualified Puerto Rican corporation which, on June 30, 1983, were stapled entities.

(B) For purposes of subparagraph (A), the term "qualified Puerto Rican corporation" means any corporation organized in Puerto Rico—

(i) which is described in section 957(c) of such Code or would be so described if any dividends it received from any other corporation described in such section 957(c) were treated as gross income of the type described in such section 957(c), and

(ii) does not, at any time during the taxable year, own (within the meaning of section 958 of such Code but before applying paragraph (2) of section 269B(a) of such Code) any stock of any corporation which is not described in such section 957(c).

(5) TREATY RULE NOT TO APPLY TO STAPLED ENTITIES ENTITLED TO TREATY BENEFITS AS OF JUNE 30, 1983.—In the case of any entity which was a stapled entity as of June 30, 1983, subsection (d) of section 269B of such Code shall not apply to any treaty benefit to which such entity was entitled as of June 30, 1983.

(6) ELECTION TO TREAT STAPLED FOREIGN ENTITIES AS SUBSIDIARIES.—

(A) IN GENERAL.—In the case of any foreign corporation and domestic corporation which as of June 30, 1983, were stapled entities, such domestic corporation may elect (in lieu of applying paragraph (1) of section 269B(a) of such Code) to be treated as owning all interests in the foreign corporation which constitute stapled interests with respect to stock of the domestic corporation.

(B) ELECTION.—Any election under subparagraph (A) shall be made not later than 180 days after the date of the enactment of this Act and shall be made in such manner as the Secretary of the Treasury or his delegate shall prescribe.

(C) ELECTION IRREVOCABLE.—Any election under subparagraph (A), once made, may be revoked only with the consent of the Secretary of the Treasury or his delegate.

Subtitle F—Miscellaneous Treasury Administrative Provisions

PART I—PROVISIONS NOT RELATING TO DISTILLED SPIRITS TAX

SEC. 461. SIMPLIFICATION OF CERTAIN REPORTING REQUIREMENTS.

(a) DISC REPORT.—

(1) Section 506 of the Revenue Act of 1971 (relating to submission of annual reports to Congress) is amended to read as follows:

"SEC. 506. SUBMISSION OF REPORTS TO CONGRESS.

"The Secretary of the Treasury shall, for the calendar year 1981 and each second calendar year thereafter, submit a report to the Congress within 27½ months following the close of such calendar year setting forth an analysis of the operation and effect of the provisions of this title."

(2) The amendment made by paragraph (1) shall apply to reports for calendar years after 1980.

(b) REPORT ON POSSESSIONS CORPORATIONS.—The Secretary of the Treasury shall, for the calendar year 1981 and each second calendar year thereafter, submit a report to the Congress within 24 months following the close of such calendar year setting forth an analysis of the operation and effect of sections 936 and 934(b) of the Internal Revenue Code of 1954.

(c) HIGH INCOME TAXPAYER REPORT.—

(1) Section 2123 of the Tax Reform Act of 1976 is amended to read as follows:

"SEC. 2123. HIGH INCOME TAXPAYER REPORT.

"The Secretary of the Treasury shall publish annually information on the amount of tax paid by individual taxpayers with high total incomes. Total income for this purpose is to be calculated and set forth by adding to adjusted gross income any items of tax preference excluded from, or deducted in arriving at, adjusted gross income, and by subtracting any investment expenses incurred in the production of such income to the extent of the investment income. These data are to include the number of such individuals with total income over $200,000 who owe no Federal income tax (after credits) and the deductions, exclusions, or credits used by them to avoid tax."

(2) The amendment made by paragraph (1) shall apply to information published after the date of the enactment of this Act.

(d) INTERNATIONAL BOYCOTT REPORTS.—

(1) Section 1067 of the Tax Reform Act of 1976 is amended to read as follows:

"**SEC. 1067. REPORTS BY THE SECRETARY.**

"(a) GENERAL RULE.—As soon after the close of each 4-year period as the data become available, the Secretary shall transmit a report to the Committee on Ways and Means of the House of Representatives and to the Committee on Finance of the Senate setting forth for such 4-year period—

"(1) the number of reports filed under section 999(a) of the Internal Revenue Code of 1954 for taxable years ending with or within each calendar year in such 4-year period,

"(2) the number of such reports with respect to each such calendar year on which the taxpayer indicated international boycott participation or cooperation (within the meaning of section 999(b)(3) of such Code), and

"(3) a detailed description of the manner in which the provisions of such Code relating to international boycott activity have been administered during such 4-year period.

"(b) 4-YEAR PERIOD.—For purposes of subsection (a), the term '4-year period' means the period consisting of 4 calendar years beginning with calendar year 1982 and each subsequent fourth calendar year."

(2) The amendment made by paragraph (1) shall apply to reports for periods after December 31, 1981.

SEC. 462. REMOVAL OF $1,000,000 LIMITATION ON WORKING CAPITAL FUND.

The last sentence of section 322(a) of title 31, United States Code (placing a $1,000,000 limitation on the working capital fund for the Department of the Treasury), is hereby repealed.

SEC. 463. INCREASE IN LIMITATION ON REVOLVING FUND FOR REDEMPTION OF REAL PROPERTY.

Subsection (a) of section 7810 (relating to revolving fund for redemption of real property) is amended by striking out "$1,000,000" and inserting in lieu thereof "$10,000,000".

SEC. 464. REMOVAL OF $1,000,000 LIMITATION ON SPECIAL AUTHORITY TO DISPOSE OF OBLIGATIONS.

Subsection (b) of section 324 of title 31, United States Code (relating to disposing and extending the maturity of obligations), is amended by striking out the last sentence.

SEC. 465. SECRETARY OF THE TREASURY AUTHORIZED TO ACCEPT GIFTS AND BEQUESTS.

Section 321 of title 31, United States Code, is amended by adding at the end thereof the following new subsection:

"(d)(1) The Secretary of the Treasury may accept, hold, administer, and use gifts and bequests of property, both real and personal, for the purpose of aiding or facilitating the work of the Department of the Treasury. Gifts and bequests of money and the proceeds from sales of other property received as gifts or bequests shall be deposited in the Treasury in a separate fund and shall be disbursed on order of the Secretary of the Treasury. Property accepted under this paragraph, and the proceeds thereof, shall be used as nearly as possible in accordance with the terms of the gift or bequest.

"(2) For purposes of the Federal income, estate, and gift taxes, property accepted under paragraph (1) shall be considered as a gift or bequest to or for the use of the United States.

"(3) The Secretary of the Treasury may invest and reinvest the fund in public debt securities with maturities suitable for the needs of the fund and bearing interest at rates determined by the Secretary of the Treasury, taking into consideration the current average market yield on outstanding marketable obligations of the United States of comparable maturities. Income accruing from the securities, and from any other property accepted under paragraph (1), shall be deposited to the credit of the fund, and shall be disbursed on order of the Secretary of the Treasury for purposes as nearly as possible in accordance with the terms of the gifts or bequests.

"(4) The Secretary of the Treasury shall, not less frequently than annually, make a public disclosure of the amount (and sources) of the gifts and bequests received under this subsection, and the purposes for which amounts in the separate fund established under this subsection are expended."

SEC. 466. EXTENSION OF PERIOD FOR COURT REVIEW OF JEOPARDY ASSESSMENT WHERE PROMPT SERVICE NOT MADE ON THE UNITED STATES.

(a) General Rule.—Paragraph (2) of section 7429(b) (relating to judicial review) is amended by adding at the end thereof the following new sentence:

> "If the court determines that proper service was not made on the United States within 5 days after the date of the commencement of the action, the running of the

20-day period set forth in the preceding sentence shall not begin before the day on which proper service was made on the United States."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to actions commenced after the date of the enactment of this Act.

SEC. 467. EXTENSION OF PERIOD DURING WHICH ADDITIONAL TAX SHOWN ON AMENDED RETURN MAY BE ASSESSED.

(a) GENERAL RULE.—Subsection (c) of section 6501 (relating to exceptions) is amended by adding at the end thereof the following new paragraph:

"(7) SPECIAL RULE FOR CERTAIN AMENDED RETURNS.—Where, within the 60-day period ending on the day on which the time prescribed in this section for the assessment of any tax imposed by subtitle A for any taxable year would otherwise expire, the Secretary receives a written document signed by the taxpayer showing that the taxpayer owes an additional amount of such tax for such taxable year, the period for the assessment of such additional amount shall not expire before the day 60 days after the day on which the Secretary receives such document."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to documents received by the Secretary of the Treasury (or his delegate) after the date of the enactment of this Act.

SEC. 468. TREATMENT OF CERTAIN GUARANTEED DRAFTS ISSUED BY FINANCIAL INSTITUTIONS.

(a) GENERAL RULE.—Paragraph (2) of section 6311(b) (relating to liability of banks and others) is amended—

(1) by striking out "or cashier's check" and inserting in lieu thereof "or cashier's check (or other guaranteed draft)",

(2) by striking out "the amount of such check" and inserting in lieu thereof "the amount of such check (or draft)",

(3) by striking out "the bank or trust company" and inserting in lieu thereof "the financial institution", and

(4) by striking out "such bank" each place it appears and inserting in lieu thereof "such financial institution".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 469. DISCLOSURE OF WINDFALL PROFIT TAX INFORMATION TO STATE TAX OFFICIALS.

(a) GENERAL RULE.—Paragraph (1) of section 6103(d) (relating to disclosure to State tax officials) is amended by striking out "44, 51" and inserting in lieu thereof "44, 45, 51".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

PART II—PROVISIONS RELATING TO DISTILLED SPIRITS

SEC. 470. REPEAL OF OCCUPATIONAL TAX ON MANUFACTURERS OF STILLS AND CONDENSERS; NOTICES OF MANUFACTURE AND SET UP OF STILLS.

(a) IN GENERAL.—Subpart C of part II of subchapter A of chapter 51 (relating to manufacturers of stills) is amended to read as follows:

"Subpart C—Manufacturers of Stills

"Sec. 5101. Notice of manufacture of still; notice of set up of still.
"Sec. 5102. Definition of manufacturer of stills.

"SEC. 5101. NOTICE OF MANUFACTURE OF STILL; NOTICE OF SET UP OF STILL.

"(a) NOTICE REQUIREMENTS.—

"(1) NOTICE OF MANUFACTURE OF STILL.—The Secretary may, pursuant to regulations, require any person who manufactures any still, boiler, or other vessel to be used for the purpose of distilling, to give written notice, before the still, boiler, or other vessel is removed from the place of manufacture, setting forth by whom it is to be used, its capacity, and the time of removal from the place of manufacture.

"(2) NOTICE OF SET UP OF STILL.—The Secretary may, pursuant to regulations, require that no still, boiler, or other vessel be set up without the manufacturer of the still, boiler, or other vessel first giving written notice to the Secretary of that purpose.

"(b) PENALTIES, ETC.—

> **"(1) For penalty and forfeiture for failure to give notice of manufacture, or for setting up a still without first giving notice, when required by the Secretary, see sections 5615(2) and 5687.**
>
> **"(2) For penalty and forfeiture for failure to register still or distilling apparatus when set up, see section 5601(a)(1) and 5615(1).**

"SEC. 5102. DEFINITION OF MANUFACTURER OF STILLS.

"Any person who manufactures any still or condenser to be used in distilling shall be deemed a manufacturer of stills."

(b) TECHNICAL AMENDMENTS.—

(1) Paragraph (2) of section 5179(b) (relating to registration of stills) is amended to read as follows:

> **"(2) For provisions requiring notification to set up a still, boiler, or other vessel for distilling, see section 5101(a)(2)."**

(2) Paragraph (2) of section 5615 (relating to property subject to forfeiture) is amended to read as follows:

"(2) DISTILLING APPARATUS REMOVED WITHOUT NOTICE OR SET UP WITHOUT NOTICE.—Any still, boiler, or other vessel to be used for the purpose of distilling—

"(A) which is removed without notice having been given when required by section 5101(a)(1), or

"(B) which is set up without notice having been given when required by section 5101(a)(2); and".

(3) Subsection (a) of section 5691 (relating to penalties for nonpayment of special taxes relating to liquors) is amended by striking out "limited retail dealer, or manufacturer of stills" and inserting in lieu thereof "or limited retail dealer".

SEC. 471. ALLOWANCE OF DRAWBACK CLAIMS EVEN WHERE CERTAIN REQUIREMENTS NOT MET.

Section 5134 (relating to drawback) is amended by adding at the end thereof the following new subsection:

"(c) Allowance of Drawback Even Where Certain Requirements Not Met.—

"(1) In general.—No claim for drawback under this section shall be denied in the case of a failure to comply with any requirement imposed under this subpart or any rule or regulation issued thereunder upon the claimant's establishing to the satisfaction of the Secretary that distilled spirits on which the tax has been paid or determined were in fact used in the manufacture or production of medicines, medicinal preparations, food products, flavors, or flavoring extracts, which were unfit for beverage purposes.

"(2) PENALTY.—

"(A) IN GENERAL.—In the case of a failure to comply with any requirement imposed under this subpart or any rule or regulation issued thereunder, the claimant shall be liable for a penalty of $1,000 for each failure to comply unless it is shown that the failure to comply was due to reasonable cause.

"(B) PENALTY MAY NOT EXCEED AMOUNT OF CLAIM.—The aggregate amount of the penalties imposed under subparagraph (A) for failures described in paragraph (1) in respect of any claim shall not exceed the amount of such claim (determined without regard to subparagraph (A)).

"(3) PENALTY TREATED AS TAX.—The penalty imposed by paragraph (2) shall be assessed, collected, and paid in the same manner as taxes, as provided in section 6662(a)."

SEC. 472. DISCLOSURE OF ALCOHOL FUEL PRODUCERS TO ADMINISTRATORS OF STATE ALCOHOL LAWS.

(a) IN GENERAL.—Subsection (l) of section 6103 (relating to confidentiality and disclosure of returns and return information) is amended by adding at the end thereof the following new paragraph:

"(9) DISCLOSURE OF ALCOHOL FUEL PRODUCERS TO ADMINISTRATORS OF STATE ALCOHOL LAWS.—Notwithstanding any other provision of this section, the Secretary may disclose—

"(A) the name and address of any person who is qualified to produce alcohol for fuel use under section 5181, and

"(B) the location of any premises to be used by such person in producing alcohol for fuel,

to any State agency, body, or commission, or its legal representative, which is charged under the laws of such State with responsibility for administration of State alcohol laws solely for use in the administration of such laws."

(b) TECHNICAL AMENDMENTS.—

(1) Subparagraph (A) of section 6103(p)(3) (relating to records of inspection and disclosure) is amended by striking out "(5), or (7)" and inserting in lieu thereof "(5), (7), (8), or (9)".

(2) The material preceding subparagraph (A) of paragraph (4) of section 6103(p) is amended by striking out "or (7)" and inserting in lieu thereof "(7), (8), or (9)".

(3) Clause (i) of section 6103(p)(4)(F) is amended by striking out "(l) (6) or (7)" and inserting in lieu thereof "(l) (6), (7), (8), or (9)".

(4) Paragraph (2) of section 7213(a) (relating to unauthorized disclosure of information) is amended by striking out "or (8)" and inserting in lieu thereof "(8), or (9)".

(5) Section 127(a)(1) of Public Law 96-249 is amended by striking out "Subsection (i)" and inserting in lieu thereof "Subsection (l)".

(6) The paragraph (7) of section 6103(l) added by Public Law 96-265 is hereby redesignated as paragraph (8).

SEC. 473. REPEAL OF STAMP REQUIREMENT FOR DISTILLED SPIRITS.

(a) In General.—Section 5205 (relating to stamps) is hereby repealed.

(b) Bottles Must Have Other Antitampering Closure.—Section 5301 is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

"(d) CLOSURES.—The immediate container of distilled spirits withdrawn from bonded premises, or from customs custody, on determination of tax shall bear a closure or other device which is designed so as to require breaking in order to gain access to the contents of such container. The preceding sentence shall not apply to containers of bulk distilled spirits."

(c) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) The second sentence of section 5062(b) (relating to drawback in case of exportation) is amended by striking out "stamped or restamped, and".

(2) Paragraph (2) of section 5066(a) (relating to bottled distilled spirits eligible for export with benefit of drawback) is amended by striking out "stamped or restamped, and marked," and inserting in lieu thereof "marked".

(3) Subsection (b) of section 5116 (relating to cross references) is amended to read as follows:

"(b) CROSS REFERENCE.—

"For provisions relating to containers of distilled spirits, see section 5206."

(4) Subsection (c) of section 5204 (relating to gauging) is amended—

(A) by striking out "STAMPING," in the heading, and

(B) by striking out "stamping," in the text.

(5)(A) Section 5206 (relating to containers) is amended by redesignating subsections (d) and (e) as subsections (e) and (f), respectively, and by inserting after subsection (c) the following new subsection:

"(d) EFFACEMENT OF MARKS AND BRANDS ON EMPTIED CONTAINERS.—Every person who empties, or causes to be emptied, any container of distilled spirits bearing any mark or brand required by law (or regulations pursuant thereto) shall at the time of emptying such container efface and obliterate such mark or brand; except that the Secretary may, by regulations, waive any requirement of this subsection where he determines that no jeopardy to the revenue will be involved."

(B) Subsection (f) of section 5206, as redesignated by subparagraph (A), is amended by adding at the end thereof the following new paragraphs:

"(3) For provisions relating to the marking and branding of containers of distilled spirits by proprietors, see section 5204(c).

"(4) For penalties and forfeitures relating to marks and brands, see sections 5604 and 5613."

(6) Paragraph (4) of section 5207(a) (relating to records and reports) is amended by striking out subparagraph (D), by adding "and" at the end of subparagraph (B), and by striking out ", and" at the end of subparagraph (C) and inserting in lieu thereof a period.

(7) Subsection (c) of section 5215 (relating to return of tax determined distilled spirits to bonded premises) is amended—

(A) by striking out "RESTAMPING" in the heading and inserting in lieu thereof "RECLOSING", and

(B) by striking out "restamping" in the text and inserting in lieu thereof "reclosing".

(8) Section 5235 (relating to bottling of alcohol for industrial purposes) is amended by striking out "stamped," in the first sentence and by striking out the second sentence.

(9) Subsection (c) of section 5301 (relating to regulation of traffic in containers of distilled spirits) is amended—

(A) by striking out "stamping" in paragraphs (1) and (3) and inserting in lieu thereof "tax determination", and

(B) by striking out ", if the liquor bottles are to be again stamped under the provisions of this chapter".

(10) Subsection (a) of section 5555 (relating to records, statements, and returns) is amended by striking out "or for the affixing of any stamp required to be affixed by this chapter,".

(11)(A) Section 5604 (relating to penalties relating to stamps, marks, brands, and containers) is amended to read as follows:

"SEC. 5604. PENALTIES RELATING TO MARKS, BRANDS, AND CONTAINERS.

"(a) IN GENERAL.—Any person who shall—

"(1) transport, possess, buy, sell, or transfer any distilled spirits unless the immediate container bears the type of closure or other device required by section 5301(d);

"(2) with intent to defraud the United States, empty a container bearing the closure or other device required by section 5301(d) without breaking such closure or other device,

"(3) empty, or cause to be emptied, any distilled spirits from an immediate container bearing any mark or brand required by law without effacing and obliterating such mark or brand as required by section 5206(d),

"(4) place any distilled spirits in any bottle, or reuse any bottle for the purpose of containing distilled spirits, which has once been filled and fitted with a closure or other device under the provisions of this chapter, without removing and destroying such closure or other device, "(5) willfully and unlawfully remove, change, or deface any mark, brand, label, or seal affixed to any case of distilled spirits, or to any bottle contained therein,

"(6) with intent to defraud the United States, purchase, sell, receive with intent to transport, or transport any empty cask or package having thereon any mark or brand required by law to be affixed to any cask or package containing distilled spirits, or

"(7) change or alter any mark or brand on any cask or package containing distilled spirits, or put into any cask or package spirits of greater strength than is indicated by the inspection mark thereon, or fraudulently use any cask or package having any inspection mark thereon, for the purpose of selling other spirits, or spirits of quantity or quality different from the spirits previously inspected,

shall be fined not more than $10,000 or imprisoned not more than 5 years, or both, for each such offense.

"(b) CROSS REFERENCES.—

"For provisions relating to the authority of internal revenue officers to enforce provisions of this section, see sections 5203, 5557, and 7608."

(B) The table of sections for part I of subchapter J of chapter 51 is amended by striking out the item relating to section 5604 and inserting in lieu thereof the following:

"Sec. 5604. Penalties relating to marks, brands, and containers."

(12)(A) Subsection (b) of section 5613 (relating to forfeiture of distilled spirits not stamped, marked, or branded as required by law) is amended to read as follows:

"(b) CONTAINERS WITHOUT CLOSURES.—All distilled spirits found in any container which is required by this chapter to bear a closure or other device and which does not bear a closure or other device in compliance with this chapter shall be forfeited to the United States."

(B) The section heading of section 5613 is amended by striking out "**STAMPED**" and inserting in lieu thereof "**CLOSED**".

(C) The item relating to section 5613 in the table of sections for part I of subchapter J of chapter 51 is amended by striking out "stamped" and inserting in lieu thereof "closed".

(13) Subsection (b) of section 6801 (relating to authority for establishment, alteration, and distribution) is amended by striking out "several stamp taxes;" and all that follows and inserting in lieu thereof "several stamp taxes."

(14) The table of sections for part I of subchapter C of chapter 51 is amended by striking out the item relating to section 5205.

SEC. 474. EFFECTIVE DATES.

(a) In General.—Except as provided in subsection (b), the amendments made by this part shall take effect on the first day of the first calendar month which begins more than 90 days after the date of the enactment of this Act.

(b) Repeal of Stamp Requirement.—The amendments made by section 473 shall take effect on July 1, 1985.

Subtitle G—Tax Court Provisions

SEC. 475. CERTIFIED PUBLIC ACCOUNTANTS AND ENROLLED AGENTS AUTHORIZED TO REPRESENT TAXPAYERS IN SMALL TAX CASES; INCREASE IN JURISDICTIONAL LIMIT FOR SMALL CASES.

(a) General Rule.—Section 7463 (relating to disputes involving $5,000 or less) is amended by adding at the end thereof the following new subsection:

"(g) Representation of Taxpayer.—In any case in which the proceedings are conducted under this section, any person who is—

"(1) a certified public accountant, or

"(2) an enrolled agent authorized to practice before the Internal Revenue Service,

shall be allowed to represent the taxpayer. Nothing in this subsection shall prevent the Tax Court from extending its rules of practice relating to suspension or disqualification to persons referred to in paragraph (1) or (2)."

(b) INCREASE IN JURISDICTIONAL LIMIT FOR SMALL TAX CASES.—

(1) IN GENERAL.—Subsection (a) of section 7463 (relating to disputes involving $5,000 or less) is amended by striking out "$5,000" each place it appears and inserting in lieu thereof "$10,000".

(2) CLERICAL AMENDMENTS.—

(A) The section heading for section 7463 is amended by striking out "**$5,000**" and inserting in lieu thereof "**$10,000**".

(B) The table of sections for part II of subchapter C of chapter 76 is amended by striking out "$5,000" in the item relating to section 7463 and inserting in lieu thereof "$10,000".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

SEC. 476. ANNUITIES TO SURVIVORS OF TAX COURT JUDGES.

(a) ENTITLEMENT TO ANNUITY.—Subsection (h) of section 7448 (relating to entitlement to annuity) is amended—

(1) by striking out "$900 per year divided by the number of such children or $360 per year," in paragraph (2) and inserting in lieu thereof "$4,644 per

year divided by the number of such children or $1,548 per year,"; and

(2) by striking out "$480 per year" in paragraph (3) and inserting in lieu thereof "$5,580 per year divided by the number of such children or $1,860 per year, whichever is lesser".

(b) EFFECTIVE DATE.—The amendments made by this subsection (a) shall apply to annuities payable with respect to months beginning after the date of the enactment of this Act.

SEC. 477. PROCEEDINGS WHICH MAY BE ASSIGNED TO COMMISSIONERS.

(a) IN GENERAL.—Subsection (d) of section 7456 (relating to proceedings which may be assigned to commissioners) is amended to read as follows:

"(d) PROCEEDINGS WHICH MAY BE ASSIGNED TO COMMISSIONERS.—The chief judge may assign—

"(1) any declaratory judgment proceeding,

"(2) any proceeding under section 7463,

"(3) any proceeding where neither the amount of the deficiency placed in dispute (within the meaning of section 7463) nor the amount of any claimed overpayment exceeds $10,000; and

"(4) any other proceeding which the chief judge may designate, to be heard by the commissioners of the court, and the court may authorize a commissioner to make the decision of the court with respect to any proceeding described in paragraph (1), (2), or (3), subject to such conditions and review as the court may provide."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect as if enacted as part of the Miscellaneous Revenue Act of 1982.

SEC. 478. SPECIAL TRIAL JUDGES.

(a) IN GENERAL.—Subsection (a) of section 7456 (relating to administration of oaths and procurement of testimony) is amended by striking out "commissioner" each place it appears and inserting in lieu thereof "special trial judge".

(b) APPOINTMENT AND COMPENSATION.—Subsection (c) of section 7456 (relating to commissioners) is amended—

(1) by striking out "COMMISSIONERS" in the heading and inserting in lieu thereof "SPECIAL TRIAL JUDGES";

(2) by striking out "commissioners" and inserting in lieu thereof "special trial judges"; and

(3) by striking out "commissioner" and inserting in lieu thereof "special trial judge".

(c) PROCEEDINGS WHICH MAY BE ASSIGNED TO SPECIAL TRIAL JUDGES.—Subsection (d) of section 7456 (relating to proceedings which may be assigned to commissioners), as amended by section 477, is amended—

(1) by striking out "COMMISSIONERS" in the heading and inserting in lieu thereof "SPECIAL TRIAL JUDGES";

(2) by striking out "commissioners" and inserting in lieu thereof "special trial judges"; and

(3) by striking out "commissioner" and inserting in lieu thereof "special trial judge".

(d) CONFORMING AMENDMENT.—Subsection (c) of section 7471 (cross reference relating to compensation and travel and subsistence allowances of commissioners) is amended by striking out "COMMISSIONERS" in the heading and inserting in lieu thereof "SPECIAL TRIAL JUDGES", and by striking out "commissioners" and inserting in lieu thereof "special trial judges".

(e) EFFECTIVE DATE.—

(1) The amendments made by this section shall take effect on the date of the enactment of this Act.

(2) Any reference in any law to a commissioner of the Tax Court shall be treated as a reference to a special trial judge of the Tax Court.

SEC. 479. PUBLICITY OF TAX COURT PROCEEDINGS.

(a) IN GENERAL.—Section 7461 (relating to publicity of proceedings) is amended to read as follows:

"SEC. 7461. PUBLICITY OF PROCEEDINGS.

"(a) General Rule.—Except as provided in subsection (b), all reports of the Tax Court and all evidence received by the Tax Court and its divisions, including a transcript of the stenographic report of the hearings, shall be public records open to the inspection of the public.

"(b) Exceptions.—

"(1) Trade secrets or other confidential information.—The Tax Court may make any provision which is necessary to prevent the disclosure of trade secrets or other confidential information, including a provision that any document or information be placed under seal to be opened only as directed by the court

"(2) Evidence, etc.—After the decision of the Tax Court in any proceeding has become final, the Tax Court may, upon motion of the taxpayer or the Secretary, permit the withdrawal by the party entitled thereto of originals of books, documents, and records, and of models, diagrams, and other exhibits, introduced in evidence before the Tax Court or any division; or the Tax Court may, on its own motion, make such other disposition thereof as it deems advisable."

(b) Effective Date.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 480. ELIMINATION OF MANDATORY RETIREMENT AGE FOR TAX COURT JUDGES.

(a) IN GENERAL.—Paragraph (1) of section 7447(b) (relating to retirement of Tax Court judges) is amended to read as follows:

"(1) Any judge may retire at any time after attaining age 70."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

Subtitle H—Simplification of Income Tax Credits

SEC. 481. SHORT TITLE.

This subtitle may be cited as the "Tax Credit Simplification Act of 1984".

SEC. 482. CREDITS GROUPED TOGETHER IN MORE LOGICAL ORDER.

(a) CREDITS DIVIDED INTO 4 CATEGORIES.—The table of subparts for part IV of subchapter A of chapter 1 (relating to credits against tax) is amended to read as follows:

"Subpart A. Nonrefundable personal credits.
"Subpart B. Foreign tax credit, etc.
"Subpart C. Refundable credits.
"Subpart D. Business-related credits."

(b) EXISTING CREDITS ASSIGNED TO APPROPRIATE CATEGORY.—Part IV of subchapter A of chapter 1 is amended by striking out the heading and table of sections for subpart A and inserting in lieu thereof the following:

"Subpart A—Nonrefundable Personal Credits

"Sec. 21. Expenses for household and dependent care services necessary for gainful employment.
"Sec. 22. Credit for the elderly and the permanently and totally disabled.
"Sec. 23. Residential energy credit.
"Sec. 24. Contributions to candidates for public office.
"Sec. 25. Limitation based on tax liability; definition of tax liability.

"Subpart B—Foreign Tax Credit, Etc.

"Sec. 27. Taxes of foreign countries and possessions of the United States; possession tax credit.
"Sec. 28. Clinical testing expenses for certain drugs for rare diseases or conditions.
"Sec. 29. Credit for producing fuel from a nonconventional source.
"Sec. 30. Credit for increasing research activities.

"Subpart C—Refundable Credits

"Sec. 31. Tax withheld on wages.
"Sec. 32. Earned income.
"Sec. 33. Tax withheld at source on nonresident aliens and foreign corporations.
"Sec. 34. Certain uses of gasoline and special fuels.
"Sec. 35. Overpayments of tax.

"Subpart D—Business Related Credits

"Sec. 38. General business credit.
"Sec. 39. Carryback and carry forward of unused credits.
"Sec. 40. Alcohol used as fuel.
"Sec. 41. Employee stock ownership credit."

(c) SECTIONS MOVED TO APPROPRIATE PLACE IN PART IV.—

(1) DESIGNATION.—The following sections of such part IV are henceforth to be designated in accordance with the following table:

Old section number:	New section number:	New subpart designation:
44A	21	A
37	22	A
44C	23	A
41	24	A
33	27	B
44H	28	B
44D	29	B
44F	30	B
31	31	C
43	32	C
32	33	C
39	34	C
45	35	C
44E	40	D
44G	41	D

(2) PLACED IN APPROPRIATE SUBPARTS.—Each section for which paragraph (1) provides a new section number is hereby moved to the appropriate place in the appropriate subpart of such part IV.

SEC. 483. UNIFORM LIMITATION ON PERSONAL NONREFUNDABLE CREDITS.

Subpart A of part IV of subchapter A of chapter 1 is amended by adding after section 24 the following new section:

"SEC. 25. LIMITATION BASED ON TAX LIABILITY; DEFINITION OF TAX LIABILITY.

"(a) LIMITATION BASED ON AMOUNT OF TAX.—The aggregate amount of credits allowed by this subpart for the taxable year shall not exceed the taxpayer's tax liability for such taxable year.

"(b) TAX LIABILITY.—For purposes of this section—

"(1) In general.—The term 'tax liability' means the tax imposed by this chapter for the taxable year.

"(2) Exception for certain taxes.—For purposes of paragraph (1), any tax imposed by any of the following provisions shall not be treated as tax imposed by this chapter:

"(A) section 56 (relating to corporate minimum tax),

"(B) subsection (m)(5)(B), (o)(2), or (q) of section 72 (relating to additional tax on certain distributions),

"(C) section 408(f) (relating to additional tax on income from certain retirement accounts),

"(D) section 531 (relating to accumulated earnings tax),

"(E) section 541 (relating to personal holding company tax),

"(F) section 1351(d)(1) (relating to recoveries of foreign expropriation losses),

"(G) section 1374 (relating to tax on certain capital gains of S corporations), and

"(H) section 1375 (relating to tax imposed when passive investment income of corporation having subchapter C earnings and profits exceeds 25 percent of gross receipts).

"(c) SIMILAR RULE FOR ALTERNATIVE MINIMUM TAX FOR TAXPAYERS OTHER THAN CORPORATIONS.—

"For treatment of tax imposed by section 55 as not imposed by this chapter, see section 55(c)."

SEC. 484. UNIFORM CARRYOVER PROVISIONS FOR BUSINESS-RELATED CREDITS.

Subpart D of part IV of subchapter A of chapter 1 is amended by inserting before section 40 the following new sections:

"SEC. 38. GENERAL BUSINESS CREDIT.

"(a) ALLOWANCE OF CREDIT.—There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the sum of—

"(1) the business credit carryforwards carried to such taxable year,

"(2) the amount of the current year business credit, plus

"(3) the business credit carrybacks carried to such taxable year.

"(b) CURRENT YEAR BUSINESS CREDIT.—For purposes of this subpart, the amount of the current year business credit is the sum of the following credits determined for the taxable year:

"(1) the investment credit determined under section 46(a), "(2) the targeted jobs credit determined under section 51(a),

"(3) the alcohol fuels credit determined under section 40(a), plus

"(4) the employee stock ownership credit determined under section 41(a).

"(c) Limitation Based on Amount of Tax.—

"(1) In general.—The credit allowed under subsection (a) for any taxable year shall not exceed the sum of—

"(A) so much of the taxpayer's net tax liability for the taxable year as does not exceed $25,000, plus

"(B) 85 percent of so much of the taxpayer's net tax liability for the taxable year as exceeds $25,000.

"(2) Net tax liability.—For purposes of paragraph (1), the term 'net tax liability' means the tax liability (as defined in section 25(b)), reduced by the sum of the credits allowable under subparts A and B of this part.

"(3) Special rules.—

"(A) Married individuals.—In the case of a husband or wife who files a separate return, the amount specified under subparagraphs (A) and

(B) of paragraph (1) shall be $12,500 in lieu of $25,000. This subparagraph shall not apply if the spouse of the taxpayer has no business credit carryforward or carryback to, and has no current year business credit for, the taxable year of such spouse which ends within or with the taxpayer's taxable year.

"(B) CONTROLLED GROUPS.—In the case of a controlled group, the $25,000 amount specified under subparagraphs (A) and (B) of paragraph (1) shall be reduced for each component member of such group by apportioning $25,000 among the component members of such group in such manner as the Secretary shall by regulations prescribe. For purposes of the preceding sentence, the term 'controlled group' has the meaning given to such term by section 1563(a).

"(C) LIMITATIONS WITH RESPECT TO CERTAIN PERSONS.—In the case of a person described in subparagraph (A) or (B) of section 46(e)(1), the $25,000 amount specified under subparagraphs (A) and (B) of paragraph (1) shall equal such person's ratable share (as determined under section 46(e)(2)) of such amount.

"(D) ESTATES AND TRUSTS.—In the case of an estate or trust, the $25,000 amount specified under subparagraphs (A) and (B) of paragraph (1) shall be reduced to an amount which bears the same ratio to $25,000 as the portion of the income of the estate or trust which is not allocated to beneficiaries bears to the total income of the estate or trust.

"(d) SPECIAL RULES FOR CERTAIN REGULATED COMPANIES.—In the case of any taxpayer to which section 46(f) applies, for purposes of sections 46(f), 47(a), 196(a), and 404(i) and any other provision of this title where it is necessary to ascertain the extent to which the credits determined under section 40(a), 41(a), 46(a), or 51(a) are used in a taxable year or as a carryback or carryforward, the order in which such credits are used shall be determined on the basis of the order in which they are listed in subsection (b).

"SEC. 39. CARRYBACK AND CARRYFORWARD OF UNUSED CREDITS.

"(a) IN GENERAL.—

"(1) 3 YEAR CARRYBACK AND 15 YEAR CARRYFORWARD.—If the sum of the business credit carryforwards to the taxable year plus the amount of the current year business credit for the taxable year exceeds the amount of the limitation imposed by subsection (c) of section 38 for such taxable year (hereinafter in this section referred to as the 'unused credit year'), such excess (to the extent attributable to the amount of the current year business credit) shall be—

"(A) a business credit carryback to each of the 3 taxable years preceding the unused credit year, and

"(B) a business credit carryforward to each of the 15 taxable years following the unused credit year,

and, subject to the limitations imposed by subsections (b) and (c), shall be taken into account under the provisions of section 38(a) in the manner provided in section 38(a).

"(2) AMOUNT CARRIED TO EACH YEAR.—

"(A) ENTIRE AMOUNT CARRIED TO FIRST YEAR.—The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the 18 taxable years to which (by reason of paragraph (1)) such credit may be carried.

"(B) AMOUNT CARRIED TO OTHER 17 YEARS.—The amount of the unused credit for the unused credit year shall be carried to each of the other 17 taxable years to the extent that such unused credit may not be taken into account under section 38(a) for a prior taxable year because of the limitations of subsections (b) and (c).

"(b) LIMITATION ON CARRYBACKS.—The amount of the unused credit which may be taken into account under section 38(a)(3) for any preceding taxable year shall not exceed the amount by which the limitation imposed by section 38(c) for such taxable year exceeds the sum of—

"(1) the amounts determined under paragraphs (1) and (2) of section 38(a) for such taxable year, plus

"(2) the amounts which (by reason of this section) are carried back to such taxable year and are attributable to taxable years preceding the unused credit year.

"(c) LIMITATION ON CARRYFORWARDS.—The amount of the unused credit which may be taken into account under section 38(a)(1) for any succeeding taxable year shall not exceed the amount by which the limitation imposed by section 38(c) for such taxable year exceeds the sum of the amounts which, by reason of this section, are carried to such taxable year and are attributable to taxable years preceding the unused credit year.

"(d) TRANSITIONAL RULES.—

"(1) CARRYFORWARDS.—

"(A) IN GENERAL.—Any carryforward from an unused credit year under section 46, 50A, 53, 44E, or 44G which has not expired before the beginning of the first taxable year beginning after December 31, 1983, shall be aggregated with other such carryforwards from such unused credit year and shall be a business credit carryforward to each taxable year beginning after December 31, 1983, which is 1 of the first 15 taxable years after such unused credit year.

"(B) AMOUNT CARRIED FORWARD.—The amount carried forward under subparagraph (A) to any taxable year shall be properly reduced for any amount allowable as a credit with respect to such carryforward for any taxable year before the year to which it is being carried.

"(2) CARRYBACKS.—In determining the amount allowable as a credit for any taxable year beginning before January 1, 1984, as the result of the carryback of a general business tax credit from a taxable year beginning after December 31, 1983, paragraph (1) of subsection (b) shall be applied as if it read as follows:

" '(1) the sum of the credits allowable for such taxable year under sections 38, 40, 44B, 44E, and 44G, plus'."

SEC. 485. TECHNICAL AND CONFORMING AMENDMENTS.

(a) REFERENCES TO OLD AND NEW PROVISIONS.—Whenever in this section reference is made to an old or new section or other provision, the reference is to the provision before (in the case of "old") or after (in the case of "new") the changes made by section 482 of this Act.

(b) OLD SECTION 21.—

(1) REDESIGNATION.—Old section 21 (relating to effect of changes) is redesignated as section 15.

(2) CONFORMING AMENDMENTS.—Sections 441(f)(2)(A) and 6013(c) are each amended by striking out "21" and inserting in lieu thereof "15".

(3) TABLE OF SECTIONS.—The table of sections for part III of subchapter A of chapter 1 is amended by striking out the item relating to section 21 and inserting in lieu thereof the following:

"Sec. 15. Effect of changes."

(c) NEW SECTION 21.—New section 21 (relating to expenses for household and dependent care services necessary for gainful employment) is amended—

(1) by striking out subsection (b) and by redesignating subsections (c), (d), (e), (f), and (g) as subsections (b), (c), (d), (e), and (f), respectively,

(2) by striking out "subsection (c)(1)" in subsection (a) and inserting in lieu thereof "subsection (b)(1)",

(3) by striking out "subsection (c)(2)" in subsection (a) and inserting in lieu thereof "subsection (b)(2)",

(4) by striking out "subsection (c)(1)(C)" in paragraph (2) of subsection (d) (as redesignated by paragraph (1)) and inserting in lieu thereof "subsection (b)(1)(C)",

(5) by striking out "subsection (d)(1)" in subparagraph (A) of subsection (d)(2) (as redesignated by paragraph (1)) and inserting in lieu thereof, "subsection (c)(1)",

(6) by striking out "subsection (d)(2)" in subparagraph (B) of subsection (d)(2) (as redesignated by paragraph (1)) and inserting in lieu thereof "subsection (c)(2)", and

(7) by striking out "subsection (c)(1)" in subsection (e)(5) (as redesignated by paragraph (1)) and inserting in lieu thereof "subsection (b)(1)".

(d) NEW SECTION 22.—New section 22 (relating to the credit for the elderly and the permanently and totally disabled) is amended—

(1) by striking out "section 37 amount" each place it appears in the text and inserting in lieu thereof "section 22 amount",

(2) by striking out the heading of subsection (c) and inserting in lieu thereof "(c) SECTION 22 AMOUNT.—", and

(3) by amending subsection (d) to read as follows:

"(d) ADJUSTED GROSS INCOME LIMITATION.—If the adjusted gross income of the taxpayer exceeds—

"(1) $7,500 in the case of a single individual,

"(2) $10,000 in the case of a joint return, or

"(3) $5,000 in the case of a married individual filing a separate return,

the section 22 amount shall be reduced by one-half of the excess of the adjusted gross income over $7,500, $10,000, or $5,000, as the case may be."

(e) NEW SECTION 23.—Subsection (b) of new section 23 (relating to residential energy credit) is amended by striking out paragraphs (5) and (6) and inserting in lieu thereof the following:

"(5) CARRYFORWARD OF UNUSED CREDIT.—

"(A) IN GENERAL.—If the credit allowable under subsection (a) for any taxable year exceeds the limitation imposed by section 25(a) for such taxable year reduced by the sum of the credits allowable under this subpart (other than this section), such excess shall be carried to the succeeding taxable year and added to the credit allowable under subsection (a) for such succeeding taxable year.

"(B) NO CARRYFORWARD TO TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1987.—No amount may be carried under subparagraph (A) to any taxable year beginning after December 31, 1987."

(f) NEW SECTION 24.—Subsection (b) of new section 24 (relating to contributions to candidates for political office) is amended by striking out paragraph (2) and by redesignating paragraph (3) as paragraph (2).

(g) NEW SECTION 28.—

(1) New section 28 is amended—

(A) by striking out "section 44F" each place it appears and inserting in lieu thereof "section 30", and

(B) by striking out "section 44F(b)" in subsection (c)(2) and inserting in lieu thereof "section 30(b)," and

(C) by striking out "section 44F(f)" in subsection (d)(4) and inserting in lieu thereof "section 30(f)".

(2) Paragraph (2) of new section 28(d) is amended to read as follows:

"(2) LIMITATION BASED ON AMOUNT OF TAX.—The credit allowed by this section for any taxable year shall not exceed the taxpayer's tax liability for the taxable year (as defined in section 25(b)), reduced by the sum of the credits allowable under subpart A and section 28."

(h) NEW SECTION 29.—Paragraph (5) of new section 29(b) (relating to credit for producing fuel from a nonconventional source) is amended to read as follows:

"(5) APPLICATION WITH OTHER CREDITS.—The credit allowed by subsection (a) for a taxable year shall not exceed the taxpayer's tax liability for the taxable year (as defined in section 25(b)), reduced by the sum of the credits allowable under subpart A and sections 27 and 28."

(i) NEW SECTION 30.—

(1) New section 30 (relating to credit for increasing research activities) is amended—

(A) by striking out "in computing the credit under section 40 or 44B" in subsection (b)(2)(D)(iii) and inserting in lieu thereof "in determining the targeted jobs credit under section 51(a)", and

(B) by amending subparagraph (A) of subsection (g)(1) to read as follows:

"(A) IN GENERAL.—Except as provided in subparagraph (B), the credit allowed by subsection (a) for any taxable year shall not exceed the taxpayer's tax liability for the taxable year (as defined in section 25(b)), reduced by the sum of the credits allowable under subpart A and sections 27, 28, and 29."

(2) NEW SECTION 30 TREATED AS CONTINUATION OF OLD SECTION 44F.—For purposes of determining—

(A) whether any excess credit under old section 44F for a taxable year beginning before January 1, 1984, is allowable as a carryover under new section 30, and

(B) the period during which new section 30 is in effect,

new section 30 shall be treated as a continuation of old section 44F (and shall apply only to the extent old section 44F would have applied).

(j) NEW SECTION 33.—New section 33 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds) is amended to read as follows:

"SEC. 33. TAX WITHHELD AT SOURCE ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS.

"There shall be allowed as a credit against the tax imposed by this subtitle the amount of tax withheld at source under subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and on foreign corporations)."

(k) NEW SECTION 40.—New section 40 (relating to alcohol used as fuel) is amended—

(1) by amending subsection (a) to read as follows:

"(a) GENERAL RULE.—For purposes of section 38, the alcohol fuels credit determined under this section for the taxable year is an amount equal to the sum of—

"(1) the alcohol mixture credit, plus

"(2) the alcohol credit.",

(2) by striking out "the credit allowable under this section" in subsection (c) and inserting in lieu thereof "the credit determined under this section",

(3) by striking out "credit was allowable" each place it appears in paragraph (3) of subsection (d) and inserting in lieu thereof "credit was determined",

(4) by striking out subsection (e) and redesignating subsection (f) as subsection (e),

(5) by amending paragraph (2) of subsection (e) (as redesignated by paragraph (4)) to read as follows:

"(2) NO CARRYOVERS TO YEARS AFTER 1994.—No amount may be carried under section 39 by reason of this section (treating the amount allowed by reason of this section as the first amount allowed by this subpart) to any taxable year beginning after December 31, 1994.", and

(6) by adding at the end thereof the following new subsection:

"(f) ELECTION TO HAVE ALCOHOL FUELS CREDIT NOT APPLY.—

"(1) IN GENERAL.—A taxpayer may elect to have this section not apply for any taxable year.

"(2) TIME FOR MAKING ELECTION.—An election under paragraph (1) for any taxable year may be made (or revoked) at any time before the expiration of the 3-year period beginning on the last date prescribed by law for filing the return for such taxable year (determined without regard to extensions).

"(3) MANNER OF MAKING ELECTION.—An election under paragraph (1) (or revocation thereof) shall be made in such manner as the Secretary may by regulations prescribe."

(l) NEW SECTION 41.—New section 41 (relating to employee stock ownership plan) is amended—

(1) by amending paragraph (1) of subsection (a) to read as follows:

"(1) AMOUNT OF CREDIT.—In the case of a corporation which elects to have this section apply for the taxable year and which meets the requirements of subsection (c)(1), for purposes of section 38, the amount of the employee stock ownership credit determined under this section for the taxable year is an amount equal to the amount of the credit determined under paragraph (2) for such taxable year.",

(2) by amending subsection (b) to read as follows:

"(b) CERTAIN REGULATED COMPANIES.—No credit attributable to compensation taken into account for the ratemaking purposes involved shall be determined under this section with respect to a taxpayer if—

"(1) the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by reason of any portion of such credit which results from the transfer of employer securities or cash to a tax credit employee stock ownership plan which meets the requirements of section 409;

"(2) the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of such credit which results from a transfer described in paragraph (1) to such employee stock ownership plan; or

"(3) any portion of the amount of such credit which results from a transfer described in paragraph (1) to such employee stock ownership plan is treated for ratemaking purposes in any way other than as though it had been contributed by the taxpayer's common shareholders.

Under regulations prescribed by the Secretary, rules similar to the rules of paragraphs (4) and (7) of section 46(f) shall apply for purposes of the preceding sentence.", and

(3) by striking out "the credit allowed under this section" in subsection (c)(3) and inserting in lieu thereof "the credit determined under this section".

(m) REPEAL OF CERTAIN OLD PROVISIONS.—

(1) Old sections 38, 40, 44, and 44B are hereby repealed.

(2) Old subpart C of part IV of subchapter A of chapter 1 is hereby repealed.

(n) REDESIGNATION OF OLD SUBPARTS.—

(1) Old subparts B and D of part IV of subchapter A of chapter 1 are redesignated as subparts E and F, respectively.

(2) The subpart heading for subpart F of part IV of subchapter A of chapter 1 (as so redesignated) is amended to read as follows:

"Subpart F—Rules for Computing Targeted Jobs Credit".

(3) The table of subparts for such part IV (as amended by subsection (a) of section 482) is amended by adding at the end thereof the following:

"Subpart E. Rules for computing credit for investment in certain depreciable property.
"Subpart F. Rules for computing targeted jobs credit."

(o) INVESTMENT TAX CREDIT.—

(1) Section 46 (relating to amount of investment tax credit) is amended by striking out subsections (a) and (b) and inserting in lieu thereof the following:

"(a) AMOUNT OF INVESTMENT CREDIT.—For purposes of section 38, the amount of the investment credit determined under this section for any taxable year shall be an amount equal to the sum of the following percentages of the qualified investment (as determined under subsections (c) and (d)):

"(1) the regular percentage,

"(2) in the case of energy property, the energy percentage, and

"(3) in the case of that portion of the basis of any property which is attributable to qualified rehabilitation expenditures, the rehabilitation percentage.

"(b) DETERMINATION OF PERCENTAGES.—For purposes of subsection (a)—

"(1) REGULAR PERCENTAGE.—The regular percentage is 10 percent.

"(2) ENERGY PERCENTAGE.—

"(A) In general.—The energy percentage shall be determined in accordance with the following table:

Column A—Description	Column B—Percentage	Column C—Period	
		For the period:	
In the case of:	The energy percentage is:	Beginning on:	And ending on:
(i) General Rule.—Property not described in any of the following provisions of this column.	10 percent	Oct. 1, 1978	Dec. 31, 1982.
(ii) Solar Wind, or Geothermal Property.—Property described in section 48(l)(2)(A)(ii) or 48(l)(3)(A)(vii).	A. 10 percent	Oct. 1, 1978	Dec. 31, 1979.
	B. 15 percent	Jan. 1, 1980	Dec. 31, 1985.
(iii) Ocean Thermal Property.—Property described in section 48(l)(3)(A)(ix).	15 percent	Jan. 1, 1980	Dec. 31, 1985.
(iv) Qualified Hydroelectric Generating Property.—Property described in section 48(l)(2)(A)(vii).	11 percent	Jan. 1, 1980	Dec. 31, 1985.
(v) Qualified Intercity Buses.—Property described in section 48(l)(2)(A)(ix).	10 percent	Jan. 1, 1980	Dec. 31, 1985.
(vi) Biomass Property.—Property described in section 48(l)(15).	10 percent	Oct. 1, 1978	Dec. 31, 1985.
(vii) Chlor-Alkali Electrolytic Cells.—Property described in section 48(l)(5)(M).	10 percent	Jan. 1, 1980	Dec. 31, 1982.

"(B) Periods for which percentage not specified.—In the case of any energy property, the energy percentage shall be zero for any period for which an energy percentage is not specified for such property under subparagraph (A) (as modified by subparagraphs (C) and (D)).

"(C) LONGER PERIOD FOR CERTAIN LONG-TERM PROJECTS.—For the purpose of applying the energy percentage contained in clause (i) of subparagraph (A) with respect to property which is part of a project with a normal construction period of 2 years or more (within the meaning of subsection (d)(2)(A)(i)), 'December 31, 1990' shall be substituted for 'December 31, 1982' if—

"(i) before January 1, 1983, all engineering studies in connection with the commencement of the construction of the project have been completed and all environmental and construction permits required under Federal, State, or local law in connection with the commencement of the construction of the project have been applied for, and

"(ii) before January 1, 1986, the taxpayer has entered into binding contracts for the acquisition, construction, reconstruction, or erection of equipment specially designed for the project and the aggregate cost to the taxpayer of that equipment is at least 50 percent of the reasonably estimated cost for all such equipment which is to be placed in service as part of the project upon its completion.

"(D) LONGER PERIOD FOR CERTAIN HYDROELECTRIC GENERATING PROPERTY.—If an application has been docketed by the Federal Energy Regulatory Commission before January 1, 1986, with respect to the installation of any qualified hydroelectric generating property, for purposes of applying the energy percentage contained in clause (iv) of subparagraph (A) with respect to such property, 'December 31, 1988' shall be substituted for 'December 31, 1985'.

"(3) SPECIAL RULE FOR CERTAIN ENERGY PROPERTY.—The regular percentage shall not apply to any energy property which, but for section 48(l)(1), would not be section 38 property. In the case of any qualified hydroelectric generating property which is a fish passageway, the preceding sentence shall not apply to any period after 1979 for which the energy percentage for such property is greater than zero.

"(4) REHABILITATION PERCENTAGE.—

"(A) IN GENERAL.—

"In the case of qualified rehabilitation expenditures with respect to a:	The rehabilitation percentage is:
30-year building	15
40-year building	20
Certified historic structure	25.

"(B) REGULAR AND ENERGY PERCENTAGES NOT TO APPLY.—The regular percentages and the energy percentages shall not apply to that portion of the basis of any property which is attributable to qualified rehabilitation expenditures.

"(C) DEFINITIONS.—For purpose of this paragraph—

"(i) 30-YEAR BUILDING.—The term '30-year building' means a qualified rehabilitated building other than a 40-year building and other than a certified historic structure.

"(ii) 40-YEAR BUILDING.—The term '40-year building' means a qualified rehabilitated building (other than a certified historic structure) which would meet the requirements of section 48(g)(B) if '40' were substituted for '30' each place it appears in subparagraph (B) thereof.

"(iii) CERTIFIED HISTORIC STRUCTURE.—The term 'certified historic structure' means a qualified rehabilitated building which meets the requirements of section 48(g)(3)."

(2) Subclause (II) of section 46(c)(8)(F)(ii) is amended by striking out "section 46(a)(2)(C)" and inserting in lieu thereof "subsection (b)(2)".

(3)(A) Paragraph (1) of section 46(e) is amended—

(i) by striking out "and the $25,000 amount specified under subparagraphs (A) and (B) of subsection (a)(3)", and

(ii) by striking out "such items" and inserting in lieu thereof "such qualified investment".

(B) Paragraph (2) of section 46(e) is amended by striking out "the items described therein" and inserting in lieu thereof "qualified investment".

(4)(A) Paragraphs (1) and (2) of section 46(f) are each amended by striking out "no credit shall be allowed by section 38" and inserting in lieu thereof "no credit determined under subsection (a) shall be allowed by section 38".

(B) Paragraphs (1) and (2) of section 46(f) are each amended by striking out "the credit allowable by section 38" each place it appears and inserting in lieu thereof "the credit determined under subsection (a) and allowable by section 38".

(C) Subparagraph (B) of section 46(f)(4) is amended by striking out "the credit allowed by section 38" and inserting in lieu thereof "the credit determined under subsection (a) and allowed by section 38".

(5) Paragraph (8) of section 46(f) is amended—

(A) by striking out "the credit allowable under section 38" each place it appears and inserting in lieu thereof "the credit determined under subsection (a) and allowable under section 38", and

(B) by striking out "(within the meaning of subsection (a)(7)(C))" and inserting in lieu thereof "(within the meaning of the first sentence of subsection (c)(3)(B))".

(6) Paragraph (2) of section 46(g) is amended by striking out "the limitation of subsection (a)(3)" and inserting in lieu thereof "the limitation of section 38(c)".

(7) Paragraph (1) of section 46(h) is amended—

(A) by striking out "the credit allowable to the organization under section 38" and inserting in lieu thereof "the credit determined under subsection (a) and allowable to the organization under section 38", and

(B) by striking out "the limitation contained in subsection (a)(3)" and inserting in lieu thereof "the limitation contained in section 38(c)".

(8) Paragraphs (5) and (6) of section 47(a) are each amended by striking out "under section 46(b)" and inserting in lieu thereof "under section 39".

(9) Subsection (c) of section 47 is amended by striking out "subpart A" and inserting in lieu thereof "subpart A, B, or D".

(10) Subparagraph (B) of section 48(c)(3) is amended by striking out "section 46(b)" and inserting in lieu thereof "section 39".

(11) Subparagraph (B) of section 48(d)(1) is amended by striking out "section 46(a)(6)" and inserting in lieu thereof "section 38(c)(3)(B)".

(12) Subsection (f) of section 48 is amended—

(A) by adding "and" at the end of paragraph (1),

(B) striking out ", and" at the end of paragraph (2) and inserting in lieu thereof a period, and

(C) by striking out paragraph (3).

(13) Paragraph (1) of section 48(l) is amended by striking out "section 46(a)(2)(C)" and inserting in lieu thereof "section 46(b)(2)".

(14) Subsection (m) of section 48 is amended by striking out "subsection (a)(2)" and inserting in lieu thereof "subsection (b)".

(15) Subsection (n) of section 48 (relating to requirements for allowance of employee plan percentage) is hereby repealed; except that paragraph (4) of section 48(n) of the Internal Revenue Code of 1954 (as in effect before its repeal by this paragraph) shall continue to apply in the case of any recapture under section 47(f) of such Code of a credit allowable for a taxable year beginning before January 1, 1984.

(16) Subsection (o) of section 48 (defining certain credits) is amended by striking out paragraphs (3), (4), (5), (6), and (7) and by redesignating paragraph (8) as paragraph (3).

(17) Subsection (q) of section 48 is amended—

(A) by striking out "section 46(a)(2)" each place it appears and inserting in lieu thereof "section 46(a)", and

(B) by striking out "section 46(a)(2)(B)" each place it appears and inserting in lieu therof "section 46(b)(1)".

(18) Subsection (r) of section 48 is amended by striking out "section 381(c)(23)" and inserting in lieu thereof "section 381(c)(26)".

(p) TARGETED JOBS CREDIT.—

(1) Subsection (a) of section 51 (relating to amount of targeted jobs credit) is amended to read as follows:

"(a) DETERMINATION OF AMOUNT.—For purposes of section 38, the amount of the targeted jobs credit determined under this section for the taxable year shall be the sum of—

"(1) 50 percent of the qualified first-year wages for such year, and

"(2) 25 percent of the qualified second-year wages for such year."

(2) Subsection (g) of section 51 is amended by striking out "the credit provided by section 44B" and inserting in lieu thereof "the targeted jobs credit determined under this subpart".

(3) Section 51 is amended by adding at the end thereof the following new subsection:

"(j) ELECTION TO HAVE TARGETED JOBS CREDIT NOT APPLY.—

"(1) IN GENERAL.—A taxpayer may elect to have this section not apply for any taxable year.

"(2) TIME FOR MAKING ELECTION.—An election under paragraph (1) for any taxable year may be made (or revoked) at any time before the expiration of the 3-year period beginning on the last date prescribed by law for filing the return for such taxable year (determined without regard to extensions).

"(3) MANNER OF MAKING ELECTION.—An election under paragraph (1) (or revocation thereof) shall be made in such manner as the Secretary may by regulations prescribe."

(4) Subsection (a) of section 52 is amended by striking out "the credit (if any) allowable by section 44B to each such member" and inserting in lieu thereof "the credit (if any) determined under section 51(a) with respect to each such member".

(5) Subsection (b) of section 52 is amended by striking out "the credit (if any) allowable by section 44B" and inserting in lieu thereof "the credit (if any) determined under section 51(a)".

(6) Subsection (c) of section 52 is amended by striking out "credit shall be allowed under section 44B" and inserting in lieu thereof "credit shall be allowed under section 38 for any targeted jobs credit determined under this subpart".

(7) Paragraph (2) of section 52(d) is amended by striking out ", subject to section 53, a credit under section 44B" and inserting in lieu thereof ", subject to section 38(c), a credit under section 38(a)".

(8) Section 53 (relating to limitation based on amount of tax) is hereby repealed.

(9) The table of sections for old subpart D of part IV of subchapter A of chapter 1 is amended by striking out the item relating to section 53.

(q) SECTION 55.—

(1) Paragraph (1) of section 55(c) (relating to credits) is amended—

(A) by striking out "subpart A of part IV" and inserting in lieu thereof "subpart A, B, or D of part IV", and

(B) by striking out "section 33(a)" each place it appears and inserting in lieu thereof "section 27(a)".

(2) Clause (i) of section 55(c)(2)(B) is amended by striking out "section 33(a)" and inserting in lieu thereof "section 27(a)".

(3) Paragraph (3) of section 55(c) is amended to read as follows:

"(3) CARRYOVER AND CARRYBACK OF CERTAIN CREDITS.—In the case of any taxable year for which a tax is imposed by this section, for purposes of determining the amount of any carryover or carryback to any other taxable year of any credit allowable under section 23, 30 or 38, the amount of the limitation under section 25, 30(g), or 38(c) (as the case may be) shall be deemed to be—

"(A) the amount of such limitation for such taxable year (determined without regard to this paragraph), reduced (but not below zero) by

"(B) the amount of the tax imposed by this section for the taxable year, reduced by—

"(i) the amount of the credit allowable under section 27(a),

"(ii) in the case of the limitation under section 30(g), the amount of such tax taken into account under this subparagraph with respect to the limitation under section 25, and

"(iii) in the case of the limitation under section 38(c), the amount of such tax taken into account under this subparagraph with respect to limitations under sections 25 and 30(g)."

(4) Paragraph (2) of section 55(f) is amended by striking out "allowable under subpart A of part IV of this subchapter (other than under sections 31, 39, and 43)" and inserting in lieu thereof "allowable under subparts A, B, and D of part IV of this subchapter".

(r) TECHNICAL AND CONFORMING AMENDMENTS TO OTHER PROVISIONS.—

(1) SECTION 56.—

(A) Subsection (c) of section 56 (defining regular tax deduction) is amended—

(i) by striking out "subpart A of part IV other than sections 39 and 44G" and inserting in lieu thereof "subparts A, B, and D of part IV", and

(ii) by amending the last sentence to read as follows: "For purposes of the preceding sentence, the amount of the credit determined under section 38 for any taxable year shall be determined without regard to the employee stock ownership credit determined under section 41."

(B) Subparagraph (A) of section 56(e)(1) is amended by striking out clauses (i), (ii), (iii), and (iv) and inserting in lieu thereof the following:

"(i) section 27 (relating to foreign tax credit), and

"(ii) section 38 (relating to general business credit), exceed".

(2) SECTION 86.—Paragraph (1) of section 86(f) (relating to treatment as pension or annuity for certain

purposes) is amended by striking out "section 43(c)(2)" and inserting in lieu thereof "section 32(c)(2)".

(3) SECTION 87.—Section 87 (relating to alcohol fuel credit included in income) is amended to read as follows:

"SEC. 87. ALCOHOL FUEL CREDIT.

"Gross income includes the amount of the alcohol fuel credit determined with respect to the taxpayer for the taxable year under section 40(a)."

(4) SECTION 103.—Clause (iv) of section 103(b)(6)(F) (relating to certain capital expenditures not taken into account) is amended by striking out "section 44F(b)(2)(A)" and inserting in lieu thereof "section 30(b)(2)(A)".

(5) SECTION 108.—Subparagraph (B) of section 108(b)(2) (relating to reduction of tax attributes in title 11 case or insolvency) is amended to read as follows:

"(B) RESEARCH CREDIT AND GENERAL BUSINESS CREDIT.—Any carryover to or from the taxable year of a discharge of an amount for purposes of determining the amount allowable as a credit under—

"(i) section 30 (relating to credit for increasing research activities), or "(ii) section 38 (relating to general business credit).

For purposes of this subparagraph, there shall not be taken into account any portion of a carryover which is attributable to the employee stock ownership credit determined under section 41."

(6) SECTION 129.—

(A) Paragraph (2) of section 129(b) (relating to earned income limitation) is amended by striking out "section 44A(e)(2)" and inserting in lieu thereof "section 21(d)(2)".

(B) Paragraph (1) of section 129(e) (defining dependent care assistance) is amended by striking out "section 44A(c)(2)" and inserting in lieu thereof "section 21(b)(2)".

(C) Paragraph (2) of section 129(e) (defining earned income) is amended by striking out "section 43(c)(2)" and inserting in lieu thereof "section 32(c)(2)".

(7) SECTION 168.—

(A) Clause (i) of section 168(i)(1)(D), as added by section 208(a) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "subpart A of part IV" and inserting in lieu thereof "subparts A, B, and D of part IV".

(B) Clause (iii) of section 168(i)(1)(D), as added by section 208(a) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "under the last sentence of section 53(a)" and inserting in lieu thereof "under section 25(b)(2)".

(C) Subparagraph (A) of section 168(i)(4), as added section 208(a) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "subpart A of part IV of subchapter A of this chapter" and inserting in lieu thereof "section 38".

(D) Clause (i) of section 168(i)(1)(D), as added by section 209(b) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "subpart A of part IV" and inserting in lieu thereof "subparts A, B, and D of part IV".

(E) Clause (iii) of section 168(i)(1)(D), as added by section 209(b) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "under the last sentence of section

53(a)" and inserting in lieu thereof "under section 25(b)(2)".

(8) SECTION 196.—

(A) Section 196 (relating to deduction for certain unused investment credits) is amended to read as follows:

"SEC. 196. DEDUCTION FOR CERTAIN UNUSED BUSINESS CREDITS.

"(a) ALLOWANCE OF DEDUCTION.—If any portion of the qualified business credits determined for any taxable year has not, after the application of section 38(c), been allowed to the taxpayer as a credit under section 38 for any taxable year, an amount equal to the credit not so allowed shall be allowed to the taxpayer as a deduction for the first taxable year following the last taxable year for which such credit could, under section 39, have been allowed as a credit.

"(b) TAXPAYER'S DYING OR CEASING TO EXIST.—If a taxpayer dies or ceases to exist before the first taxable year following the last taxable year for which the qualified business credits could, under section 39, have been allowed as a credit, the amount described in subsection (a) (or the proper portion thereof) shall, under regulations prescribed by the Secretary, be allowed to the taxpayer as a deduction for the taxable year in which such death or cessation occurs.

"(c) Qualified Business Credits.—For purposes of this section, the term 'qualified business credits' means—

"(1) the investment credit determined under section 46(a) (but only to the extent attributable to property the basis of which is reduced by section 48(q)),

"(2) the targeted jobs credit determined under section 51(a), and

"(3) the alcohol fuels credit determined under section 40(a).

"(d) Special Rule for Investment Tax Credit.—In the case of the investment credit determined under section 46(a) (other than a credit to which section 48(q)(3) applies), subsection (a) shall be applied by substituting "an amount equal to 50 percent of" for "an amount equal to".

(B) The table of sections for part VI of subchapter B of chapter 1 is amended by striking out the item relating to section 196 and inserting in lieu thereof:

"Sec. 196. Deduction for certain unused business credits."

(9) Section 213.—Subsection (e) of section 213 (relating to exclusion of amounts allowed for care of certain dependents) is amended by striking out "section 44A" and inserting in lieu thereof "section 21".

(10) Section 280C.—

(A) Section 280C (relating to certain expenses for which credits are allowable) is amended by striking out subsection (a) and by redesignating subsections (b) and (c) as subsections (a) and (b), respectively.

(B) Subsection (a) of section 280C (as so redesignated) is amended—

(i) by striking out the first sentence and inserting in lieu thereof the following: "No deduction shall be allowed for that portion of the wages or salaries paid or incurred for the taxable year which is equal to the amount of the credit determined for the taxable year under section 51(a).", and

(ii) by striking out "SECTION 44B CREDIT" in the subsection heading and inserting in lieu thereof "TARGETED JOBS CREDIT".

(C) Subsection (b) of section 280C (as so redesignated) is amended by striking out "44H" each place it appears and inserting in lieu thereof "29".

(D) Paragraph (3) of section 280C(b) (as so redesignated) is amended—

(i) by striking out "section 44F(f)(5)" and inserting in lieu thereof "section 30(f)(5)",

(ii) by striking out "section 44F(f)(1)(B)" and inserting in lieu thereof "section 30(f)(1)(B)",

(iii) by striking out "section 44F(f)(1)" and inserting in lieu thereof "section 30(f)(1)".

(11) SECTION 381.—Subsection (c) of section 381 is amended—

(A) by striking out paragraphs (23), (24), (26), (27), and (30),

(B) by redesignating paragraphs (25), (28), and (29) as paragraphs (23), (24), and (25), respectively,

(C) by striking out "44F" each place it appears in paragraph (25) (as so redesignated) and inserting in lieu thereof "30", and

(D) by adding at the end thereof the following new paragraph:

"(26) CREDIT UNDER SECTION 38.—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 38, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 38 in respect of the distributor or transferor corporation."

(12) SECTION 383.—

(A) Section 383 (as in effect on the day before the date of the enactment of the Tax Reform Act of 1976) is amended—

(i) by striking out "with respect to any unused investment credit" and all that follows and inserting in lieu thereof the following: "with respect to any unused business credit of the corporation which can otherwise be carried forward under section 39, to any unused credit of the corporation which could otherwise be carried forward under section 30(g)(2), to any excess foreign taxes of the corporation which could otherwise be carried forward under section 904(c), and to any net capital loss of the corporation which can otherwise be carried forward under section 1212.", and

(ii) by striking out the section heading and inserting in lieu thereof the following:

"SEC. 383. SPECIAL LIMITATIONS ON UNUSED BUSINESS CREDITS, RESEARCH CREDITS, FOREIGN TAXES, AND CAPITAL LOSSES."

(B) Section 383 (as amended by the Tax Reform Act of 1976) is amended—

(i) by striking out "with respect to any unused investment credit" and all that follows and inserting in lieu thereof the following: "with respect to any unused business credit of the corporation under section 39, to any unused credit of the corporation under section 30(g)(2), to any excess foreign taxes of the corporation under section 904(c), and to any net capital loss of the corporation under section 1212.", and

(ii) by striking out the section heading and inserting in lieu thereof the following:

"SEC. 383. SPECIAL LIMITATIONS ON UNUSED BUSINESS CREDITS, RESEARCH CREDITS, FOREIGN TAXES, AND CAPITAL LOSSES."

(C) The table of sections for part V of subchapter C of chapter 1 is amended by striking out the item relating to section 383 and inserting in lieu thereof the following:

"Sec. 383. Special limitations on unused business credits, research credits, foreign taxes, and capital losses."

(13) Paragraph (21) of section 401(a) is amended by striking out "allowable—" and all that follows and inserting in lieu thereof "allowable under section 41 if the employer made the transfer described in section 41(c)(1)(B)."

(14) SECTION 404.—Subsection (i) of section 404 (relating to deductibility of unused portions of employee stock ownership credit) is amended to read as follows:

"(i) DEDUCTIBILITY OF UNUSED PORTIONS OF EMPLOYEE STOCK OWNERSHIP CREDIT.—

"(1) UNUSED CREDIT CARRYOVERS.—If any portion of the employee stock ownership credit determined under section 41 for any taxable year has not, after the application of section 38(c), been allowed under section 38 for any taxable year, such portion shall be allowed as a deduction (without regard to any limitations provided under this section) for the last taxable year to which such portion could have been allowed as a credit under section 39.

"(2) REDUCTIONS IN CREDIT.—There shall be allowed as a deduction (subject to the limitations provided under this section) an amount equal to any reduction of the credit allowed under section 41 resulting from a final determination of such credit to the extent such reduction is not taken into account under section 41(c)(3)."

(14) SECTION 409.—

(A) Section 409 (relating to qualifications for tax credit employee stock ownership plans), as redesignated by section 497 of this Act, is amended by striking out "44G" each place it appears in subsections (b), (g), (i), (m), and (n) and inserting in lieu thereof "41".

(B) Paragraph (1) of section 409(b), as so redesignated, is amended by striking out "48(n)(1)(A) or".

(C) Subsection (g) of section 409, as so redesignated, is amended by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, the references to section 48(n)(1) and the employee plan credit shall refer to such section and credit as in effect before the enactment of the Tax Law Simplification and Improvement Act of 1983."

(D) Subparagraph (A) of section 409(i)(1), as so redesignated, is amended by striking out "48(n)(1) or".

(E) Subsection (k) of section 409, as so redesignated, is amended by adding at the end thereof the following new sentence: "For purposes of this subsection, the reference to the matching employee plan credit shall refer to such credit as in effect before the enactment of the Tax Law Simplification and Improvement Act of 1983."

(16) SECTION 527(g)(1).—Paragraph (1) of section 527(g) (relating to treatment of newsletter funds) is amended by striking out "section 41(c)(2)" and inserting in lieu thereof "section 24(c)(2)".

(17) SECTION 642(a)(2).—Paragraph (2) of section 642(a) (relating to credit for political contributions) is amended by striking out "section 41" and inserting in lieu thereof "section 24".

(18) SECTION 691(b).—Subsection (b) of section 691 (relating to allowance of deductions and credit) is amended by striking out "section 33" each place it appears and inserting in lieu thereof "section 27".

(19) SECTIONS 874(a) AND 882(C)(2).—Sections 874(a) and 882(c)(2) are each amended—

(A) by striking out "32" and inserting in lieu thereof "33", and

(B) by striking out "section 39" and inserting in lieu thereof "section 34".

(20) SECTION 901(a).—Subsection (a) of section 901 (relating to allowance of foreign tax credit) is amended by striking out the last sentence and inserting in lieu thereof the following: "The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 25(b)."

(21) SECTION 904(g).—Subsection (g) of section 904 (relating to limitation on foreign tax credit) is amended to read as follows:

"(g) COORDINATION WITH NONREFUNDABLE PERSONAL CREDITS.—In the case of an individual, for purposes of subsection (a), the tax against which the credit is taken is such tax reduced by the sum of the credits allowable under subpart A of part IV of subchapter A of this chapter."

(22) SECTION 936.—

(A) Clause (i)(I)(a) of section 936(h)(5)(C) is amended by striking out "section 44F(b)" and inserting in lieu thereof "section 30(b)".

(B) Clause (i)(IV)(c) of section 936(h)(5)(C) is amended—

(i) by striking out "section 44F" and inserting in lieu thereof "section 30", and

(ii) by striking out "section 44F(f)" and inserting in lieu thereof "section 30(f)".

(23) SECTION 1016(a)(21).—Paragraph (21) of section 1016(a) (relating to adjustments to basis) is amended—

(A) by striking out "section 44C(e)" and inserting in lieu thereof "section 23(e)", and

(B) by striking out "section 44C" and inserting in lieu thereof "section 23".

(24) SECTION 1033(g)(3)(A).—Subparagraph (A) of section 1033(g)(3) (relating to election to treat outdoor advertising displays as real property) is amended by striking out "the credit allowed by section 38 (relating to investment in certain depreciable property)" and inserting in lieu thereof "the investment credit determined under section 46(a)".

(25) SECTION 1351(i).—Subsection (i) of section 1351 (relating to adjustments for succeeding years) is amended—

(A) by striking out "section 33" and inserting in lieu thereof "section 27", and

(B) by striking out "section 38 (relating to investment credit)" and inserting in lieu thereof "section 38 (relating to general business credit)".

(26) SECTION 1366(f).—Paragraph (1) of section 1366(f) (relating to special rules) is amended by striking out "section 39" each place it appears and inserting in lieu thereof "section 34".

(27) SECTION 1374(b).—Subsection (b) of section 1374 (relating to amount of tax imposed on certain capital gains) is amended by striking out "section 39" and inserting in lieu thereof "section 34".

(28) SECTION 1375(c).—Paragraph (1) of section 1375(c) (relating to disallowance of credit) is amended

by striking out "section 39" and inserting in lieu thereof "section 34".

(29) SECTION 1451.—

(A) Chapter 3 (relating to withholding of tax on nonresident aliens and foreign corporations and tax-free covenant bonds) is amended by striking out subchapter B and by redesignating subchapter C as subchapter B.

(B) The table of subchapters for chapter 3 is amended by striking out the items relating to subchapters B and C and inserting in lieu thereof the following:

"SUBCHAPTER B. Application of withholding provisions."

(C) The heading of chapter 3 is amended by striking out "**AND TAX-FREE COVENANT BONDS**".

(D) The table of chapters for subtitle A is amended by striking out "and tax-free covenant bonds" in the item relating to chapter 3.

(E) Section 12 is amended by striking out paragraph (6) and by redesignating paragraphs (7) and (8) as paragraphs (6) and (7), respectively.

(F) Subsection (f) of section 164 (as in effect before its redesignation by the Social Security Amendments of 1983) is amended by striking out paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

(G) Subsection (a) of section 1441 is amended by striking out "except in the cases provided for in section 1451 and".

(H) Paragraph (3) of section 1441(c) is amended by striking out "section 1451" and inserting in lieu thereof "section 1451 (as in effect before its repeal by the Tax Credit Simplification Act of 1983)".

(I) Subsection (a) of section 1442 is amended—

(i) by striking out "or section 1451", and

(ii) by striking out "; except that, in the case of interest described in section 1451 (relating to tax-free covenant bonds), the deduction and withholding shall be at the rate specified therein".

(J) Paragraph (2) of section 6049(b) (relating to amounts not treated as interest) is amended—

(i) by adding "and" at the end of subparagraph (C),

(ii) by striking out ", and" at the end of subparagraph (D) and inserting in lieu thereof a period, and

(iii) by striking out subparagraph (E).

(K) Paragraph (16) of section 7701(a) is amended by striking out "1451,".

(30) SECTION 6096(b).—Subsection (b) of section 6096 (defining income tax liability) is amended by striking out "allowable under sections 33, 37, 38, 40, 41, 42, 44, 44A, 44B, 44C, 44D, 44E, 44F, 44G, and 44H" and inserting in lieu thereof "allowable under part IV of subchapter A of chapter 1 (other than subpart C thereof)".

(31) SECTION 6201(a)(4).—Paragraph (4) of section 6201(a) (relating to erroneous credit under section 39 or 43) is amended—

(A) by striking out "section 39" and inserting in lieu thereof "section 34",

(B) by striking out "section 43" and inserting in lieu thereof "section 32", and

(C) by striking out "SECTION 39 OR 43" in the paragraph heading and inserting in lieu thereof "SECTION 32 OR 34".

(32) SECTION 6211(b).—

(A) Paragraph (1) of section 6211(b) is amended by striking out "without regard to so much of the credit under section 32 as exceeds 2 percent of the interest on obligations described in section 1451" and inserting in lieu thereof "without regard to the credit under section 33".

(B) Paragraph (4) of section 6211(b) is amended by striking out "section 39" and inserting in lieu thereof "section 34".

(33) SECTION 6213(h)(3).—Paragraph (3) of section 6213(h) is amended by striking out "section 39" and inserting in lieu thereof "section 32 or 34".

(34) SECTION 6362(c)(1).—Paragraph (1) of section 6362(c) (relating to qualified resident tax which is a percentage of the Federal tax) is amended by striking out "sections 31 and 39" and inserting in lieu thereof "sections 31 and 34".

(35) SECTION 6401(b).—Subsection (b) of section 6401 (relating to excessive credits treated as overpayments) is amended to read as follows:

"(b) EXCESSIVE CREDITS—

"(1) IN GENERAL.—If the amount allowable as credits under subpart C of part IV of subchapter A of chapter 1 (relating to refundable credits) exceeds the tax imposed by subtitle A (reduced by the credits allowable under subparts A, B, and D of such part IV), the amount of such excess shall be considered an overpayment.

"(2) SPECIAL RULE FOR CREDIT UNDER SECTION 33.—For purposes of paragraph (1), any credit allowed under section 33 (relating to withholding of tax on nonresident aliens and on foreign corporations) for any taxable year shall be treated as a credit allowable under subpart C of part IV of subchapter A of chapter 1 only if an election under subsection (g) or (h) of section 6013 is in effect for such taxable year."

(36) SECTION 6411.—

(A) So much of subsection (a) of section 6411 as precedes paragraph (2) thereof (relating to tentative carryback and refund adjustments) is amended to read as follows:

"(a) APPLICATION FOR ADJUSTMENT.—A taxpayer may file an application for a tentative carryback adjustment of the tax for the prior taxable year affected by a net operating loss carryback provided in section 172(b), by a business credit carryback provided in section 39, by a research credit carryback provided in section 30(g)(2) or by a capital loss carryback provided in section 1212(a)(1), from any taxable year. The application shall be verified in the manner prescribed by section 6065 in the case of a return of such taxpayer and shall be filed, on or after the date of filing for the return for the taxable year of the net operating loss, net capital loss, or unused business credit from which the carryback results and within a period of 12 months after such taxable year or, with respect to any portion of a research credit carryback or a business credit carryback attributable to a net operating loss carryback or a net capital loss carryback from a subsequent taxable year, within a period of 12 months from the end of such subsequent taxable year (or, with respect to any portion of a business credit carryback attributable to a research credit carryback from a subsequent taxable year within a period of 12 months from the end of such subsequent taxable year), in the manner and form required by regulations prescribed by the Secretary. The applications shall set forth in such detail and with such supporting data and explanation as such regulations shall require—

"(1) The amount of the net operating loss, net capital loss, unused research credit, or unused business credit;".

(B) Subsections (b) and (c) of section 6411 are each amended by striking out "unused investment credit, unused work incentive program credit, unused new employee credit, unused research credit, or unused employee stock ownership credit" each place it appears and inserting in lieu thereof "unused research credit, or unused business credit".

(37) SECTIONS 6420(g)(2), ETC.—Sections 6420(g)(2), 6421(i)(3), and 6427(i)(3) are each amended by striking out "section 39" and inserting in lieu thereof "section 34".

(38) SECTION 6501(p).—Section 6501 is amended by striking out subsection (p) and by redesignating subsection (q) as subsection (p).

(39) SECTION 6511(d)(4)(C).—Subparagraph (C) of section 6511(d)(4) (defining credit carryback) is amended to read as follows:

"(C) CREDIT CARRYBACK DEFINED.—For purposes of this paragraph, the term 'credit carryback' means any business carryback under section 39 and any research credit carryback under section 30(g)(2)."

(40) SECTION 7871.—Subparagraph (A) of section 7871(a)(6) is amended by striking out "section 41(c)(4)" and inserting in lieu thereof "section 24(c)(4)".

(41) SECTION 9502(d).—Paragraph (3) of section 9502(d) (relating to transfers from the Airport and Airway Trust Fund on account of certain section 39 credits) is amended—

(A) by striking out "section 39" and inserting in lieu thereof "section 34", and

(B) by striking out "SECTION 39 CREDITS" in the heading and inserting in lieu thereof "SECTION 34 CREDITS".

(42) SECTION 9503(c).—Clause (ii) of section 9503(c)(2)(A) (relating to transfers from the Highway Trust Fund for certain repayments and credits) is amended by striking out "section 39" and inserting in lieu thereof "section 34".

SEC. 486. EFFECTIVE DATES.

(a) GENERAL RULE.—The amendments made by this title shall apply to taxable years beginning after December 31, 1983, and to carrybacks from such years.

(b) TAX-FREE COVENANT BONDS.—The amendments made by subsections (i) and (r)(29) of section 485 shall not apply with respect to obligations issued before January 1, 1984.

Subtitle I—Miscellaneous Simplification Provisions

SEC. 491. ROLLOVER OF CERTAIN PARTIAL DISTRIBUTIONS PERMITTED.

(a) GENERAL RULE.—

(1) QUALIFIED TRUSTS.—Clause (i) of section 402(a)(5)(A) (relating to rollover amounts) is amended to read as follows—

"(i) any portion of the balance to the credit of an employee in a qualified trust is paid to him,".

(2) QUALIFIED ANNUITIES.—Clause (i) of section 403(a)(4)(A) (relating to rollover amounts) is amended to read as follows:

"(i) any portion of the balance to the credit of an employee in an employee annuity described in paragraph (1) is paid to him,".

(3) SECTION 403(b) ANNUITIES.—Clause (i) of section 403(b)(8)(A) (relating to rollover amounts) is amended to read as follows:

"(i) any portion of the balance to the credit of an employee in an annuity contract described in paragraph (1) is paid to him,".

(b) SPECIAL RULES FOR ROLLOVERS OF PARTIAL DISTRIBUTIONS.—Paragraph (5) of section 402(a) is amended by redesignating subparagraphs (D) and (E) as subparagraphs (E) and (F), respectively, and by inserting after subparagraph (C) the following new subparagraph:

"(D) SPECIAL RULES FOR PARTIAL DISTRIBUTIONS.—

"(i) REQUIREMENTS.—Subparagraph (A) shall apply to a partial distribution only if—

"(I) such distribution is of an amount equal to at least 50 percent of the balance to the credit of the employee in a qualified trust (determined immediately before such distribution and with regard to subsection (e)(4)(C)),

"(II) such distribution is not one of a series of periodic payments, and

"(III) the employee elects (at such time and in such manner as the Secretary shall by regulations prescribe) to have subparagraph (A) apply to such partial distribution.

"(ii) PARTIAL DISTRIBUTIONS MAY BE TRANSFERRED ONLY TO INDIVIDUAL RETIREMENT PLANS.—In the case of a partial distribution, a plan described in subclause (IV) or (V) of subparagraph (E)(iv) shall not be treated as an eligible retirement plan.

"(iii) DENIAL OF 10-YEAR AVERAGING AND CAPITAL GAINS TREATMENT FOR SUBSEQUENT DISTRIBUTIONS.—If an election under clause (i) is made with respect to any partial distribution paid to any employee—

"(I) paragraph (2) of this subsection,

"(II) paragraphs (1) and (3) of subsection (e), and

"(III) paragraph (2) of section 403(a),

shall not apply to any distribution (paid after such partial distribution) of the balance to the credit of such employee under the plan under which such partial distribution was made (or under any other plan which, under subsection (e)(4)(C), would be aggregated with such plan).

"(iv) SPECIAL RULE FOR UNREALIZED APPRECIATION.—If an election under clause (i) is made with respect to any partial distribution, the second and third sentences of paragraph (1) shall not apply to such distribution."

(c) PARTIAL DISTRIBUTIONS PAID TO SPOUSE OF EMPLOYEE AFTER EMPLOYEE'S DEATH ELIGIBLE FOR ROLLOVER.—

(1) IN GENERAL.—Paragraph (7) of section 402(a) (relating to rollover where spouse receives lump-sum distribution at death of employee) is amended to read as follows:

"(7) ROLLOVER WHERE SPOUSE RECEIVES DISTRIBUTIONS AFTER DEATH OF EMPLOYEE.—If any distribution attributable to an employee is paid to the spouse of the employee after the employee's death, paragraph (5) shall apply to such distribution in the same manner as if the spouse were the employee."

(2) ESTATE TAX TREATMENT.—Subsection (e) of section 2039 (relating to exclusion of individual retirement accounts, etc.) is amended by striking out "section 402(a)(5)" and inserting in lieu thereof "section 402(a)(5) (without regard to section 402(a)(7))".

(d) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) The following provisions are each amended by striking out "qualifying rollover distribution" each place it appears and inserting in lieu thereof "qualified total distribution"—

(A) section 402(a)(5)(B),

(B) section 402(a)(5)(E)(i) (as redesignated by subsection (b)), and

(C) section 402(a)(6)(E)(i).

(2) Subparagraph (B) of section 402(a)(5) is amended by adding at the end thereof the following new sentence: "In the case of any partial distribution, the maximum amount transferred to which subparagraph (A) applies shall not exceed the portion of such distribution which is includible in gross income (determined without regard to subparagraph (A))."

(3) Clause (ii) of section 402(a)(5)(E) (as redesignated by subsection (b)) is amended by striking out "gross income" and inserting in lieu thereof "gross income (determined without regard to this paragraph)".

(4) Clause (v) of subparagraph (E) of section 402(a)(5) (as redesignated by subsection (b)) is amended to read as follows:

> "(v) PARTIAL DISTRIBUTION.—The term 'partial distribution' means any distribution to an employee of any portion of the balance to the credit of such employee in a qualified trust; except that such term shall not include any distribution which is a qualified total distribution."

(5) Subparagraph (F) of section 402(a)(5) (as redesignated by subsection (b)) is amended by striking out "subparagraph (D)(iv)" each place it appears and inserting in lieu thereof "subparagraph (E)(iv)".

(6) Paragraph (6) of section 402(a) is amended by striking out "paragraph (5)(D)(i)" each place it appears and inserting in lieu thereof "paragraph (5)(E)(i)".

(7) Clauses (iii) and (iv) of section 402(a)(6)(D) are each amended by striking out "employee contributions" and inserting in lieu thereof "employee contributions (or, in the case of a partial distribution, the amount not includible in gross income)".

(8) Clause (i) of section 402(a)(6)(E) is amended by striking out "paragraph (5)(D)(i)(II)" and inserting in lieu thereof "paragraph (5)(D) or (5)(E)(i)(II)".

(9) Subparagraph (B) of section 403(a)(4) is amended by striking out "(B) through (E)" and inserting in lieu thereof "(B) through (F)".

(10) Subparagraph (B) of section 403(b)(8) is amended to read as follows:

"(B) SPECIAL RULES FOR PARTIAL DISTRIBUTIONS.—

"(i) IN GENERAL.—In the case of any distribution other than a total distribution, rules similar to the rules of clauses (i) and (ii) of section 402(a)(5)(D) shall apply.

"(ii) TOTAL DISTRIBUTION.—For purposes of subparagraph (A), the term 'total distribution' means one or more distributions from an annuity contract described in paragraph (1) which would constitute a lump-sum distribution within the meaning of section 402(e)(4)(A) (determined without regard to subparagraphs (B) and (H) of section 402(e)(4)) if such annuity contract were described in subsection (a), or 1 or more distributions of accumulated deductible employee contributions (within the meaning of section 7205).

"(iii) AGGREGATION OF ANNUITY CONTRACTS.—For purposes of this paragraph, all annuity contracts described in paragraph (1) purchased by an employer shall be treated as a single contract, and section 402(e)(4)(C) shall not apply."

(11) Subparagraph (C) of section 403(b)(8) is amended by striking out "(D)(v), and (E)(i)" and inserting in lieu thereof "(F)(i)".

(12) Clause (ii) of section 408(d)(3)(A) is amended by striking out "rollover contribution from an employee's trust" and inserting in lieu thereof "rollover contribution of a qualified total distribution (as defined in section 402(a)(5)(E)(i)) from an employee's trust".

(13) Subparagraph (C) of section 409(b)(3) is amended by striking out the second sentence and inserting in lieu thereof the following new sentences: "This subparagraph does not apply in the case of a transfer to such an employee's trust or such an annuity unless no part of the value of such proceeds is attributable to any source other than a qualified rollover contribution. For purposes of the preceding sentence, the term 'qualified rollover contribution' means any rollover contribution of a qualified total distribution (as defined in section 402(a)(5)(E)(i)) which is from such an employee's trust or annuity plan (other than an annuity plan or a trust forming part of a plan under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under such plan), and which did not qualify as a rollover contribution by reason of section 402(a)(7)."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions made after the date of the enactment of this Act, in taxable years ending after such date.

SEC. 492. PREFERRED STOCK ELIGIBLE UNDER SECTION 1244.

(a) GENERAL RULE.—Subsections (c)(1) and (d)(2) of section 1244 (relating to losses on small business stock) are each amended by striking out "common stock" and inserting in lieu thereof "stock".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to stock issued after the date of the enactment of this Act in taxable years ending after such date.

SEC. 493. MEDICAL CARE DEDUCTION ALLOWED FOR LODGING AWAY FROM HOME IN CERTAIN CASES.

(a) IN GENERAL.—Subsection (d) of section 213 (relating to definitions for purposes of the deduction for medical, dental, etc., expenses), as amended by section 424(b), is amended by redesignating paragraphs (2), (3), (4), (5), (6), and (7) as paragraphs (3), (4), (5), (6), (7), and (8), respectively, and by inserting after paragraph (1) the following new paragraph:

"(2) AMOUNTS PAID FOR CERTAIN LODGING AWAY FROM HOME TREATED AS PAID FOR MEDICAL CARE.—Amounts paid for lodging (not lavish or extravagant under the circumstances) while away from home primarily for and essential to medical care referred to in paragraph (1)(A) shall be treated as amounts paid for medical care if—

"(A) the medical care referred to in paragraph (1)(A) is provided by a physician in a licensed hospital (or in a medical care facility which is related to, or the equivalent of, a licensed hospital), and

"(B) there is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount taken into account under the preceding sentence shall not exceed $50 for each night for each individual."

(b) TECHNICAL AMENDMENT.—

(1) Paragraph (7) of section 213(d), as redesignated by subsection (a), is amended by striking out "paragraph (5)" and inserting in lieu thereof "paragraph (6)".

(2) Paragraph (6) of section 152(e), as amended by section 424 of this Act, is amended by striking out "section 213(d)(4)" and inserting in lieu thereof "section 213(d)(5)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

SEC. 494. STUDY OF SIMPLIFIED TAX ON GROSS INCOME.

(a) GENERAL RULE.—The Secretary of the Treasury shall conduct a study of the advisability of replacing the current Federal income tax system with a simplified tax based on gross income. Such study shall examine the advisability of replacing only the individual income tax and both the individual income tax and corporate income tax with a simplified tax based on gross income.

(b) FACTORS TO BE TAKEN INTO ACCOUNT.—In conducting the study under subsection (a), the Secretary of the Treasury shall take into account (among other factors) the following:

(1) protecting the economically disadvantaged;

(2) reducing administrative complexity;

(3) reducing paperwork, auditing requirements, tax evasion, and expediting the resolution of taxpayer-government disputes;

(4) increasing economic incentives for capital formation and productivity;

(5) removing economic disincentives to employment; and

(6) excluding certain items (such as social security benefits) from gross income.

(c) REPORT.—Not later than the date 6 months after the date of the enactment of this Act, the Secretary of the Treasury shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on the study conducted under this section.

Subtitle J—Repeal of Certain Obsolete Provisions

SEC. 497. TERMINATION OF RULES RELATING TO QUALIFIED BOND PURCHASE PLANS AND RETIREMENT BONDS WITH RESPECT TO BONDS ISSUED AFTER DECEMBER 31, 1983.

(a) QUALIFIED BOND PURCHASE PLANS.—Section 405 (relating to qualified bond purchase plans) is hereby repealed.

(b) RETIREMENT BONDS.—Section 409 (relating to retirement bonds) is hereby repealed.

(c) EXISTING BONDS MAY BE ROLLED OVER INTO QUALIFIED EMPLOYER PLANS.—

(1) Subparagraph (A) of section 405(d)(3) (as in effect before its repeal by subsection (a)) is amended to read as follows:

"(A) IN GENERAL.—If—

"(i) any qualified bond is redeemed,

"(ii) any portion of the excess of the proceeds from such redemption over the basis of such bond is transferred to an individual retirement plan which is maintained for the benefit of the individual redeeming such bond, or to a qualified trust (as defined in section 402(a)(5)(D)(iii)) for the benefit of such individual, and "(iii) such transfer is made on or before the 60th day after the individual received the proceeds of such redemption,

then gross income shall not include the proceeds to the extent so transferred and the transfer shall be treated as a rollover contribution described in section 408(d)(3)."

(2) Subsection (e) of section 402 (relating to tax on lump-sum distributions) is amended by adding at the end thereof the following new paragraph:

"(5) SPECIAL RULE WHERE PORTION OF LUMP-SUM DISTRIBUTION ATTRIBUTABLE TO ROLLOVER OF BOND PURCHASED UNDER QUALIFIED BOND PURCHASE PLAN.—If any portion of a lump-sum distribution is attributable to a transfer described in section 405(d)(3)(A)(ii) (as in effect before its repeal by the Tax Law Simplification and Improvement Act of 1983), paragraphs (1) and (3) of this subsection and paragraph (2) of subsection (a) shall not apply to such portion."

(d) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Paragraph (2) of section 55(f) (defining regular tax) is amended by striking "409(c),".

(2) Paragraph (7) of section 62 (defining adjusted gross income) is amended—

(A) by striking out "the deductions allowed by section 404 and section 405(c)" and inserting in lieu thereof "the deduction allowed by section 404", and

(B) by striking out "ANNUITY, AND BOND PURCHASE" in the heading and inserting in lieu thereof "AND ANNUITY".

(3) Paragraph (1) of section 72(o) is amended by striking out "402, 403, and 405" and inserting in lieu thereof "402 and 403".

(4) Paragraph (4) of section 72(o) is amended by striking out "408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(5) Subparagraph (D) of section 172(d)(4) is amended by striking out "or section 405(c)".

(6) Paragraph (2) of section 219(d) is amended by striking out "405(d)(3), 408(d)(3), or 409(b)(3)(C)" and inserting in lieu thereof "or 408(d)(3)".

(7) Paragraph (1) of section 219(e) is amended by striking out the last sentence.

(8) Paragraph (3) of section 219(e) is amended by striking out subparagraph (C), by adding "and" at the end of subparagraph (B) and by redesignating subparagraph (D) as subparagraph (C).

(9) Clause (iv) of section 402(a)(5)(D) is amended by striking out subclause (III) and by redesignating subclauses (IV) and (V) as subclauses (III) and (IV), respectively.

(10) Clause (i) of section 402(a)(5)(E) is amended by striking out ", (II), or (III)" and inserting in lieu thereof "or (II)".

(11) Clause (ii) of section 402(a)(5)(E) is amended by striking out "(IV) or (V)" and inserting in lieu thereof "(III) or (IV)".

(12) The last sentence of section 403(b)(1) is amended by striking out "or 409(b)(3)(C)".

(13) Subsection (a) of section 406 is amended by striking out ", an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a)" and inserting in lieu thereof "or an annuity plan described in section 403(a)".

(14) Paragraph (3) of section 406(a) is amended by striking out ", 403(a), or 405(a)" and inserting in lieu thereof "or 403(a)".

(15) Subsection (d) of section 406 is amended—

(A) by striking out "sections 404 and 405(c)" and inserting in lieu thereof "section 404",

(B) by striking out "annuity, or bond purchase" and inserting in lieu thereof "or annuity", and

(C) by striking out "(or section 405(c))" in paragraph (2) thereof.

(16) Paragraph (1) of section 407(a) is amended by striking out ", an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a)" and inserting in lieu thereof "or an annuity plan described in section 403(a)".

(17) Subparagraph (B) of section 407(a)(1) is amended by striking out ", 403(a), or 405(a)" and inserting in lieu thereof "or 403(a)".

(18) Subsection (d) of section 407 is amended—

(A) by striking out "sections 404 and 405(c)" and inserting in lieu thereof "section 404",

(B) by striking out "annuity, or bond purchase" and inserting in lieu thereof "or annuity", and

(C) by striking out "(or section 405(c))" in paragraph (2) thereof.

(19) Paragraph (1) of section 408(a) is amended by striking out "403(b)(8), 405(d)(3), or 409(b)(3)(C)" and inserting in lieu thereof "or 403(b)(8)".

(20) Clause (i) of section 408(d)(3)(A) is amended by striking out "or retirement bond".

(21) Subparagraph (B) of section 408(d)(3) is amended by striking out ", individual retirement annuity, or a retirement bond" and inserting in lieu thereof "or an individual retirement annuity".

(22) Clause (ii) of section 408(d)(3)(D) (relating to partial rollovers) is amended by striking out "bond,".

(23) Paragraph (6) of section 408(d) is amended—

(A) by striking out ", individual retirement annuity, or retirement bond" and inserting in lieu thereof "or an individual retirement annuity", and

(B) by striking out ", annuity, or bond" and inserting in lieu thereof "or annuity".

(24) Subparagraph (E) of section 408(k)(3) is amended by striking out ", 403(a), or 405(a)" and inserting in lieu thereof "or 403(a)".

(25) Paragraph (2) of section 412(a) is amended by striking out "or 405(a)".

(26) Subsection (h) of section 414 is amended by striking out "or 405(a)".

(27) Subsection (l) of section 414 is amended by striking out "or 405".

(28) Paragraph (2) of section 415(a) is amended by striking out subparagraph†(D), by striking out "or"

at the end of subparagraph (C), by adding "or" at the end of subparagraph (B), and by striking out "405(a),".

(29) Subparagraph (A) of section 415(b)(2) is amended by striking out "408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(30) Subparagraph (B) of section 415(b)(2) is amended by striking out "408(d)(3) and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(31) Paragraph (2) of section 415(c) is amended by striking out "405(d)(3), 408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(32) Paragraph (1) of section 415(k) is amended by striking out subparagraphs (C) and (H), by redesignating subparagraphs (D), (E), (F), and (G) as subparagraphs (C), (D), (E), and (F), respectively, by striking out ", or" at the end of subparagraph (F) (as so redesignated) and inserting in lieu thereof a period, and by adding "or" at the end of subparagraph (E) (as so redesignated).

(33) Paragraph (2) of section 457(e) is amended by striking out subparagraph (C) and by redesignating subparagraphs (D) and (E) as subparagraphs (C) and (D), respectively.

(34) Subsection (e) of section 2039 is amended—

(A) by striking out paragraph (3),

(B) by striking out ", or" at the end of paragraph (2) and inserting in lieu thereof a period,

(C) by adding "or" at the end of paragraph (1),

(D) by striking out "405(d)(3), 408(d)(3), or 409(b)(3)(C)" and inserting in lieu thereof "or 408(d)(3)", and

(E) by striking out ", annuity, or bond" each place it appears and inserting in lieu thereof "or annuity".

(35) Paragraph (5) of section 2517(a) is amended by striking out ", an individual retirement annuity described in section 408(b), or a retirement bond described in section 409(a)" and inserting in lieu thereof "or an individual retirement annuity described in section 408(b)".

(36) Paragraph (5) of section 3121(a) is amended by striking out subparagraph (C) and by redesignating subparagraphs (D) through (G) as subparagraphs (C) through (F), respectively.

(37) Paragraph (5) of section 3306(b) is amended by striking out subparagraph (C) and by redesignating subparagraphs (D) through (G) as subparagraphs (C) through (F), respectively.

(38) Paragraph (12) of section 3401(a) is amended by striking out subparagraph (C) and by redesignating subparagraph (D) as subparagraph (C).

(39) Subsection (e) of section 209 of the Social Security Act is amended by inserting "(as in effect before the enactment of the Tax Law Simplification and Improvement Act of 1983)" after "Internal Revenue Code of 1954" in paragraph (4) thereof.

(40) Subsection (a) of section 4972 is amended by striking out the last sentence and inserting in lieu thereof "This section applies only to plans which include a trust described in section 401(a) or which are described in section 403(a)."

(41) Subsection (a) of section 4973 is amended—

(A) by striking out paragraph (3),

(B) by striking out "or" at the end of paragraph (2),

(C) by adding "or" at the end of paragraph (1),

(D) by striking out ", annuities, or bonds" and inserting in lieu thereof "or annuities", and

(E) by striking out ", annuity, or bond" and inserting in lieu thereof "or annuity".

(42) Subparagraph (A) of section 4973(b)(1) is amended by striking out "408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(43) The last sentence of section 4973(b) is amended by striking out ", individual retirement annuity, or bond" and inserting in lieu thereof "or the individual retirement annuity".

(44) Paragraph (1) of section 4973(c) is amended by striking out ", 408(d)(3)(A)(iii), or 409(b)(3)(C)" and inserting in lieu thereof "or 408(d)(3)(A)(iii)".

(45) The last sentence of section 4975(d) is amended by striking out ", individual retirement annuity, or an individual retirement bond (as defined in section 408 or 409)" and inserting in lieu thereof "or an individual retirement annuity (as defined in section 408)".

(46) Paragraph (1) of section 4975(e) is amended—

(A) by striking out "or 405(a)",

(B) by striking out "or a retirement bond described in section 409",

(C) by striking out "annuity, or bond" and inserting in lieu thereof "or annuity", and

(D) by striking out "account, or bond" and inserting in lieu thereof "or account".

(47) Section 6047 is amended by striking out subsection (c) and by redesignating subsections (d), (e), and (f) as subsections (c), (d), and (e), respectively.

(48) Subsection (e) of section 6058 is amended by striking out paragraph (2) and by redesignating paragraphs (3) and (4) as paragraphs (2) and (3), respectively.

(49) Clause (i) of section 6104(a)(1)(B) is amended by striking out ", 403(a), or 405(a)" and inserting in lieu thereof "or 403(a)".

(50) Subsection (f) of section 6652 is amended by striking out "and bond purchase".

(51) Section 7207 is amended by striking out "or (c)".

(52) Subsection (c) of section 7476 is amended by striking out paragraph (3), by striking out ", or" at the end of paragraph (2) and inserting in lieu thereof a period, and by adding ", or" at the end of paragraph (1).

(53) Paragraph (37) of section 7701(a) is amended by striking out subparagraph (C), by striking out ", and" at the end of subparagraph (B) and inserting in lieu thereof a period, and by adding "and" at the end of subparagraph (A).

(54) The table of sections of subpart A of part I of subchapter D of chapter 1 is amended by striking out the items relating to sections 405 and 409.

(55) The section heading for section 4973 is amended by striking out "**CERTAIN INDIVIDUAL RETIREMENT ANNUITIES, AND CERTAIN RETIREMENT BONDS**" and inserting in lieu thereof "**AND CERTAIN INDIVIDUAL RETIREMENT ANNUITIES**".

(56) The table of sections for chapter 43 is amended by striking out "certain individual retirement annuities, and certain retirement bonds" in the item relating to section 4973 and inserting in lieu thereof "and certain individual retirement annuities".

(57) The section heading for section 6047 is amended by striking out "**AND BOND PURCHASE**".

(58) The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by striking out "and bond purchase" in the item relating to section 6047.

(59) The first sentence of section 3107 of title 31, United States Code, is amended by inserting before the period ", as in effect before the enactment of the Tax Law Simplification and Improvement Act of 1983".

(e) SECTION 409A REDESIGNATED AS SECTION 409.—

(1) The section heading for section 409A is amended by striking out "**SEC. 409A.**" and inserting in lieu thereof "**SEC. 409.**".

(2) Subsection (c)(1)(A)(i) of old section 44G is amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(3) Paragraph (6) of old section 44G(c) is amended by striking out "section 409A(l)" and inserting in lieu thereof "section 409(l)".

(4) Paragraph (22) of section 401(a) is amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(5) Paragraph (23) of section 401(a) is amended by striking out "section 409A(h)" each place it appears and inserting in lieu thereof "section 409(h)".

(6) Clause (ii) of section 415(c)(6)(B) is amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(7) The last sentence of section 1504(a) is amended by striking out "for section 409A(l)" and inserting in lieu thereof "of section 409(l)".

(8) Paragraph (7) of section 4975(e) is amended—

(A) by striking out "section 409A(h)" and inserting in lieu thereof "section 409(h)",

(B) by striking out "section 409A(e)(4)" and inserting in lieu thereof "section 409(e)(4)", and

(C) by striking out "section 409A(e)" and inserting in lieu thereof "section 409(e)".

(9) Paragraph (8) of section 4975(e) is amended by striking out "section 409A(l)" and inserting in lieu thereof "section 409(l)".

(10) Paragraphs (1) and (3) of section 6699(a) are each amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(11) The table of sections for subpart A of part I of subchapter D of chapter 1 is amended by striking out "Sec. 409A" and inserting in lieu thereof "Sec. 409".

(f) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments and repeals made by subsections (a), (b), and (d) shall apply to obligations issued after December 31, 1983.

(2) SUBSECTION (c).—The amendment made by subsection (c) shall apply to redemptions after the date of the enactment of this Act in taxable years ending after such date.

(3) SUBSECTION (e).—The amendments made by subsection (e) shall take effect on January 1, 1984.

(4) BONDS UNDER QUALIFIED BOND PURCHASE PLANS MAY BE REDEEMED AT ANY TIME.—Notwithstanding—

(A) subparagraph (D) of section 405(b)(1) of the Internal Revenue Code of 1954 (as in effect before its repeal by this section), and

(B) the terms of any bond described in subsection (b) of such section 405,

such a bond may be redeemed at any time after the date of the enactment of this Act in the same manner as if the individual redeeming the bond had attained age 59½.

(5) TREATMENT OF TAX IMPOSED UNDER SECTION 409(c).—For purposes of section 26(b) of the Internal Revenue Code of 1954 (as amended by this Act), any tax imposed by section 409(c) of such Code (as in effect before its repeal by this section) shall be treated as a tax imposed by section 408(f) of such Code.

SEC. 498. REPEAL OF RULES RELATING TO GAINS FROM DISPOSITION OF PROPERTY USED IN FARMING WHERE FARM LOSSES OFFSET NONFARM INCOME.

(a) In General.—Section 1251 (relating to gain from disposition of property used in farming where farm losses offset nonfarm income) is hereby repealed.

(b) Technical and Conforming Amendments.—

(1) Section 170.—

(A) The second sentence of section 170(e)(1) (relating to certain contributions of ordinary income and capital gain property) is amended by striking out "1251(c),".

(B) Subparagraph (C) of section 170(e)(3) (relating to special rule for certain contributions of inventory and other property) is amended by striking out "1251,".

(2) Section 341.—Paragraph (12) of section 341(e) (relating to nonapplication of section 1245(a)) is amended by striking out "1251(c),".

(3) Section 453B.—The second sentence of section 453B(d)(2) (relating to liquidations to which section 337 applies) is amended by striking out "1251(c),".

(4) SECTION 751.—The second sentence of subsection (c) of section 751 (defining unrealized receivables) is amended—

(A) by striking out "farm recapture property (as defined in section 1251(e)(1)),", and

(B) by striking out "1251(c),".

(5) SECTION 1252.—The second sentence of section 1252(a)(1) (relating to gains from disposition of farm land) is amended by striking out ", except that this section shall not apply to the extent section 1251 applies to such gain".

(c) CLERICAL AMENDMENT.—The table of sections for part IV of subchapter P of chapter 1 is amended by striking out the item relating to section 1251.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

TITLE V—TAX TREATMENT OF FRINGE BENEFITS

SEC. 501. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This title may be cited as the "Permanent Tax Treatment of Fringe Benefits Act of 1984".

(b) TABLE OF CONTENTS.—

TITLE V—TAX TREATMENT OF FRINGE BENEFITS

Sec. 501. Short title; table of contents.
Sec. 502. Exclusion of certain fringe benefits from gross income.
Sec. 503. Exclusion of certain reductions in tuition from gross income.

SEC. 502. EXCLUSION OF CERTAIN FRINGE BENEFITS FROM GROSS INCOME.

(a) EXCLUSION OF CERTAIN FRINGE BENEFITS.—

(1) IN GENERAL.—Part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by redesignating section 132 as section 133 and by inserting after section 131 the following new section:

"SEC. 132. CERTAIN FRINGE BENEFITS.

"(a) EXCLUSION FROM GROSS INCOME.—Gross income shall not include any fringe benefit which qualifies as a—

"(1) no-additional-cost service,

"(2) qualified employee discount,

"(3) working condition fringe, or

"(4) de minimis fringe.

"(b) NO-ADDITIONAL-COST SERVICE DEFINED.—For purposes of this section, the term 'no-additional-cost service' means any service provided by an employer to an employee for use by such employee if—

"(1) such service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services, and

"(2) the employer incurs no substantial additional cost (including forgone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service).

"(c) QUALIFIED EMPLOYEE DISCOUNT DEFINED.—For purposes of this section—

"(1) QUALIFIED EMPLOYEE DISCOUNT.—The term 'qualified employee discount' means any employee discount with respect to qualified property or services to the extent such discount does not exceed—

"(A) in the case of property, the gross profit percentage of the price at which the property is being offered by the employer to customers, or

"(B) in the case of services, 20 percent of the price at which the services are being offered by the employer to customers.

"(2) GROSS PROFIT PERCENTAGE.—

"(A) IN GENERAL.—The term 'gross profit percentage' means the percent which—

"(i) the excess of the aggregate sales price of property sold by the employer to customers over the aggregate cost of such property to the employer, is of

"(ii) the aggregate sales price of such property.

"(B) DETERMINATION OF GROSS PROFIT PERCENTAGE.—Gross profit percentage shall be determined on the basis of—

"(i) all property offered to customers in the ordinary course of the line of business of the employer in which the employee is performing services (or a reasonable classification of property selected by the employer), and

"(ii) the employer's experience during a representative period.

"(3) EMPLOYEE DISCOUNT DEFINED.—The term 'employee discount' means the amount by which—

"(A) the price at which the property or services are provided to the employee by the employer, is less than

"(B) the price at which such property or services are being offered by the employer to customers.

"(4) QUALIFIED PROPERTY OR SERVICES.—The term 'qualified property or services' means any property (other than real property and other than personal property of a kind held for investment) or services which are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services.

"(d) WORKING CONDITION FRINGE DEFINED.—For purposes of this section, the term 'working condition fringe' means any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167.

"(e) DE MINIMIS FRINGE DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'de minimis fringe' means any property or service the value of which is so small as to make accounting for it unreasonable or administratively impracticable.

"(2) AGGREGATION RULE.—For purposes of applying paragraph (1), all small-value property or services provided with respect to an individual during any calendar year which (but for subsection (a)(4)) would be includible in gross income shall be aggregated.

"(3) TREATMENT OF CERTAIN EATING FACILITIES.—The operation by an employer of any eating facility for employees shall be treated as a de minimis fringe (and shall not be aggregated under paragraph (2)) if—

"(A) such facility is located on or near the business premises of the employer, and

"(B) revenue derived from such facility normally equals or exceeds the direct operating costs of such facility.

The preceding sentence shall apply with respect to any officer, owner, or highly compensated employee only if access to the facility is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees.

"(f) CERTAIN INDIVIDUALS TREATED AS EMPLOYEES FOR PURPOSES OF SUBSECTIONS (a)(1) AND (2).—For purposes of paragraphs (1) and (2) of subsection (a)—

"(1) RETIRED AND DISABLED EMPLOYEES AND SURVIVING SPOUSE OF EMPLOYEE TREATED AS EMPLOYEE.—With respect to a line of business of an employer, the term 'employee' includes—

"(A) any individual who was formerly employed by such employer in such line of business and who separated from service with such employer in such line of business by reason of retirement or disability, and

"(B) any widow or widower of any individual who died while employed by such employer in such line of business or while an employee within the meaning of subparagraph (A).

"(2) SPOUSE AND DEPENDENT CHILDREN.—

"(A) IN GENERAL.—Any use by the spouse or a dependent child of the employee shall be treated as use by the employee.

"(B) DEPENDENT CHILD.—For purposes of subparagraph (A), the term 'dependent child' means any child (as defined in section 151(e)(3)) of the employee—

"(i) who is a dependent of the employee (or of the widow or widower described in paragraph (1)(B)), or

"(ii) both of whose parents are deceased.

For purposes of the preceding sentence, any child to whom section 152(e) applies shall be treated as the dependent of both parents.

"(g) SPECIAL RULES RELATING TO EMPLOYER.—For purposes of this section—

"(1) CONTROLLED GROUPS, ETC.—All employees treated as employed by a single employer under subsection (b), (c), or (m) of section 414 shall be treated as employed by a single employer for purposes of this section.

"(2) RECIPROCAL AGREEMENTS.—For purposes of paragraph (1) of subsection (a), any service provided by an employer to an employee of another employer shall be treated as provided by the employer of such employee if—

"(A) such service is provided pursuant to a written agreement between such employers, and

"(B) neither of such employers incurs any substantial additional cost (including forgone revenue) in providing such service or pursuant to such agreement.

"(h) SPECIAL RULES.—

"(1) EXCLUSIONS UNDER SUBSECTION (a)(1) AND (2) APPLY TO OFFICERS, ETC., ONLY IF NO DISCRIMINATION.—Paragraphs (1) and (2) of subsection (a) shall apply with respect to any fringe benefit described therein provided with respect to any officer, owner, or highly compensated employee only if such fringe benefit is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees.

"(2) SPECIAL RULE FOR LEASED SECTIONS OF DEPARTMENT STORES.—

"(A) IN GENERAL.—For purposes of paragraph (2) of subsection (a), in the case of a leased section of a department store—

"(i) such section shall be treated as part of the line of business of the person operating the department store, and

"(ii) employees in the leased section shall be treated as employees of the person operating the department store.

"(B) LEASED SECTION OF DEPARTMENT STORE.—For purposes of subparagraph (A), a leased section of a department store is any part of a department store where over-the-counter sales of property are made under a lease or similar arrangement where it appears to the general public that individuals making such sales are employed by the person operating the department store.

"(3) AUTO SALESMEN.—

"(A) IN GENERAL.—For purposes of subsection (a)(3), qualified automobile demonstration use shall be treated as a working condition fringe.

"(B) QUALIFIED AUTOMOBILE DEMONSTRATION USE.—For purposes of subparagraph (A), the term 'qualified automobile demonstration use' means any use of an automobile by an automobile salesman in the sales area in which the automobile dealer's sales office is located if—

"(i) such use is provided primarily to facilitate the salesman's performance of services for the employer, and

"(ii) there are substantial restrictions on the personal use of such automobile by such salesman.

"(4) PARKING.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'working condition fringe' includes providing parking to an employee on or near the business premises of the employer.

"(B) SPECIAL RULE FOR OFFICERS, ETC.—The term 'working condition fringe' shall not include providing parking on or near the business premises of the employer to an officer, owner, or highly compensated employee unless such parking is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees.

"(5) ON-PREMISES GYMS AND OTHER ATHLETIC FACILITIES.—

"(A) IN GENERAL.—Gross income shall not include the value of any on-premises athletic facility provided by an employer to his employees.

"(B) ON-PREMISES ATHLETIC FACILITY.—For purposes of this paragraph, the term 'on-premises athletic facility' means any gym or other athletic facility—

"(i) which is located on the premises of the employer,

"(ii) which is operated by the employer, and

"(iii) substantially all the use of which is by employees of the employer, their spouses, and their dependent children (within the meaning of subsection (f)).

"(i) CUSTOMERS NOT TO INCLUDE EMPLOYEES.—For purposes of this section (other than subsection (c)(2)(B)), the term 'customers' shall only include customers who are not employees.

"(j) SECTION NOT TO APPLY TO FRINGE BENEFITS EXPRESSLY PROVIDED FOR ELSEWHERE.—This section (other than subsection (e)) shall not apply to any fringe benefits of a type the tax treatment of which is expressly provided for in any other section of this chapter.

"(k) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section."

(2) CLERICAL AMENDMENT.—The table of sections for such part III is amended by striking out the item relating to section 132 and inserting in lieu thereof the following:

"Sec. 132. Certain fringe benefits.
"Sec. 133. Cross references to other Acts."

(b) DEFINITION OF CAFETERIA PLAN.—

(1) IN GENERAL.—Paragraph (1) of section 125(d) (defining cafeteria plan) is amended to read as follows:

"(1) IN GENERAL.—The term 'cafeteria plan' means a written plan under which—

"(A) all participants are employees, and

"(B) the participants may choose among 2 or more benefits consisting of cash and statutory nontaxable benefits."

(2) DEFINITION OF STATUTORY NONTAXABLE BENEFIT.—Subsection (f) of section 125 is amended to read as follows:

"(f) STATUTORY NONTAXABLE BENEFITS DEFINED.—For purposes of this section, the term 'statutory nontaxable benefit' means any benefit which, with the application of subsection (a), is not includible in the gross income of the employee by reason of an express provision of this chapter (other than section 117, 124, 127, or 132). Such term includes any group term life insurance which is includible in gross income only because it exceeds the dollar limitation of section 79."

(3) TECHNICAL AMENDMENT.—Subsection (c) of section 125 is amended by striking out "nontaxable benefits" each place it appears and inserting in lieu thereof "statutory nontaxable benefits".

(c) CONFORMING AMENDMENTS TO EMPLOYMENT TAXES.—

(1) SOCIAL SECURITY TAXES.—

(A) Subsection (a) of section 3121 (defining wages) is amended by striking out "or" at the end of paragraph (18), by striking out the period at the end of paragraph (19) and inserting in lieu thereof "; or", and by inserting after paragraph (19) the following new paragraph:

"(20) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117 or 132."

(B) Section 209 of the Social Security Act is amended by striking out "or" at the end of subsection (q), by striking out the period at the end of subsection (r) and inserting in lieu thereof "; or", and by inserting after subsection (r) the following new subsection:

"(s) Any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117 or 132 of the Internal Revenue Code of 1954."

(2) RAILROAD RETIREMENT TAX.—Subsection (e) of section 3231 (defining compensation) is amended by adding at the end thereof the following new paragraph:

"(5) The term 'compensation' shall not include any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117 or 132."

(3) UNEMPLOYMENT TAX.—Subsection (b) of section 3306 (defining wages) is amended by striking out "or" at the end of paragraph (13), by striking out the period at the end of paragraph (14) and inserting in lieu thereof "; or", and by inserting after paragraph (14) the following new paragraph:

"(15) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117 or 132."

(4) WITHHOLDING.—Subsection (a) of section 3401 (defining wages) is amended by striking out "or" at the end of paragraph (18), by striking out the period at the end of paragraph (19) and inserting in lieu thereof "; or", and by adding at the end thereof the following new paragraph:

"(20) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117 or 132."

(d) DETERMINATION OF LINE OF BUSINESS IN CASE OF AFFILIATED GROUP OPERATING RETAIL DEPARTMENT STORE.—If—

(1) as of October 5, 1983, the employees of one member of an affiliated group were entitled to employee discounts at the retail department stores operated by another member of such affiliated group, and

(2) the primary business of the affiliated group is the operation of retail department stores,

then, for purposes of applying section 132(a)(2) of the Internal Revenue Code of 1954, with respect to discounts provided for such employees at the retail department stores operated by such other member, the employer shall be treated as engaged in the same line of business as such other member.

(e) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1984.

SEC. 503. EXCLUSION OF CERTAIN REDUCTIONS IN TUITION FROM GROSS INCOME .

(a) IN GENERAL.—Section 117 (relating to scholarships and fellowship grants) is amended by adding at the end thereof the following new subsection:

"(d) QUALIFIED TUITION REDUCTIONS.—

"(1) IN GENERAL.—Gross income shall not include any qualified tuition reduction.

"(2) QUALIFIED TUITION REDUCTION.—For purposes of this subsection, the term 'qualified tuition reduction' means the amount of any reduction in tuition provided to an employee of an organization described in section 170(b)(1)(A)(ii) for the education (below the graduate level) at such organization (or another organization described in section 170(b)(1)(A)(ii)) of—

"(A) such employee, or

"(B) any person treated as an employee (or whose use is treated as an employee use) under the rules of section 132(f).

Such term also includes the amount of any reduction in tuition provided to an employee of an organization described in section 170(b)(1)(A)(ii) for the education at the graduate level at such organization of such employee if such employee is a teaching or research associate or assistant at such organization.

"(3) REDUCTION MUST NOT DISCRIMINATE IN FAVOR OF HIGHLY COMPENSATED, ETC.—Paragraph (1) shall apply with respect to any qualified tuition reduction provided with respect to any officer, owner, or highly compensated employee only if such reduction is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees. For purposes of the preceding sentence, a classification which includes all employees of the organization who are members of its faculty shall be treated as a reasonable classification."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to qualified tuition reductions (as defined in section 117(d)(2) of the Internal Revenue Code of 1954) for education furnished after June 30, 1984, in taxable years ending after such date.

TITLE VI—TECHNICAL CORRECTIONS

SEC. 601. SHORT TITLE; ETC.

(a) Short Title.—This title may be cited as the "Technical Corrections Act of 1984".

(b) Table of Contents.—

TITLE VI—TECHNICAL CORRECTIONS

Sec. 601. Short title; etc.

Subtitle A—Amendments Related to the Tax Equity and Fiscal Responsibility Act of 1982

Sec. 611. Technical corrections of provisions relating to individuals.
Sec. 612. Technical corrections of provisions primarily related to businesses.
Sec. 613. Technical corrections of pension provisions.
Sec. 614. Miscellaneous provisions.
Sec. 615. Effective date.

Subtitle B—Amendments Related to Subchapter S Revision Act of 1982; Etc.

Sec. 621. Technical corrections of Subchapter S Revision Act of 1982.
Sec. 622. Miscellaneous provisions.

Subtitle C—Amendments Relating to Highway Revenue Act of 1982

Sec. 631. Value of used components furnished by first user not taken into account in determining price.
Sec. 632. Clarification of application of gasoline excise tax to gasohol, etc.
Sec. 633. Certain chain operators of retail gasoline stations treated as producers.
Sec. 634. Other technical amendments.
Sec. 635. Repeal of certain provisions made obsolete by Highway Revenue Act of 1982.
Sec. 636. Effective date.

Subtitle D—Amendments to Other Laws

Part I—Changes in OASDI, Public Assistance, and Related Provisions of the Social Security Act

Sec. 641. Changes in title II of the Social Security Act necessitated by the 1983 Amendments.
Sec. 642. Changes in text of the 1983 Amendments.
Sec. 643. Other technical corrections in the Social Security Act and related provi-

sions.
Sec. 644. Effective dates.

PART II—CHANGES IN MEDICARE-RELATED PROVISIONS OF THE SOCIAL SECURITY ACT

Sec. 646. Changes in medicare provisions relating to the 1983 Amendments.
Sec. 647. Enrollment and premium penalty with respect to working aged provision.
Sec. 648. Other technical corrections in medicare-related provisions of the Social Security Act and related Acts.

(c) COORDINATION WITH OTHER TITLES.—For purposes of applying the amendments made by any title of this Act other than this title, the provisions of this title shall be treated as having been enacted immediately before the provisions of such other titles.

Subtitle A—Amendments Related to the Tax Equity and Fiscal Responsibility Act of 1982

SEC. 611. TECHNICAL CORRECTIONS OF PROVISIONS RELATING TO INDIVIDUALS.

(a) AMENDMENTS RELATED TO SECTION 201.—

(1) DEFINITION OF REGULAR TAX.—Paragraph (2) of section 55(f) (defining regular tax) is amended by striking out "sections 72(m)(5)(B)" and inserting in lieu thereof "sections 47(a), 72(m)(5)(B)".

(2) SPECIAL ELECTION FOR INTANGIBLE DRILLING AND DEVELOPMENT COSTS LIMITED TO WELLS LOCATED IN THE UNITED STATES.—Subparagraph (A) of section 58(i)(4) (relating to special election for intangible drilling and development cost not allocable to interest as limited partner) is amended by inserting

"(with respect to wells located in the United States)" after "intangible drilling costs".

(3) 3-YEAR AMORTIZATION FOR CIRCULATION EXPENSES.—

(A) Subparagraph (B) of section 57(a)(6) (relating to circulation and research and experimental expenditures) is amended to read as follows:

"(B) the amount which would have been allowable for the taxable year with respect to expenditures paid or incurred during such taxable year if—

"(i) the circulation expenditures described in section 173 had been capitalized and amortized ratably over the 3-year period beginning with the taxable year in which such expenditures were made, or

"(ii) the research and experimental expenditures described in section 174 had been capitalized and amortized ratably over the 10-year period beginning with the taxable year in which such expenditures were made."

(B) Paragraph (1) of section 58(i) (relating to optional 10-year writeoff of certain tax preferences) is amended by striking out "10-year period" and inserting in lieu thereof "10-year period (3-year period in the case of circulation expenditures described in section 173)".

(C) Subsection (b) of section 173 is amended by striking out "10-year" and inserting in lieu thereof "3-year".

(4) LOSSES TREATED AS INVESTMENT LOSSES.—Subparagraph (B) of section 55(e)(8) is amended to read as follows:

"(B) INCOME AND LOSSES TAKEN INTO ACCOUNT IN COMPUTING QUALIFIED NET INVESTMENT INCOME.—Any income or loss derived from a limited business interest shall be taken into account in computing qualified net investment income."

(b) AMENDMENT RELATED TO SECTION 202.—Paragraph (5) of section 213(d) (relating to definitions) is amended by striking out "paragraph (2)" and inserting in lieu thereof "paragraph (4)".

(c) AMENDMENTS RELATED TO SECTION 203.—

(1) CLARIFICATION OF ADJUSTED GROSS INCOME IN THE CASE OF ESTATES AND TRUSTS.—Paragraph (2) of section 165(h) (relating to casualty and theft losses) is amended by redesignating subparagraph (B)

as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

"(B) DETERMINATION OF ADJUSTED GROSS INCOME IN CASE OF ESTATES AND TRUSTS.—For purposes of paragraph (1), the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that the deductions for costs paid or incurred in connection with the administration of the estate or trust shall be treated as allowable in arriving at adjusted gross income."

(2) COORDINATION OF SECTION 165(h) WITH SECTION 1231.—Paragraph (2) of section 165(h) (relating to casualty and theft losses) is amended by adding at the end thereof the following new subparagraph:

"(D) COORDINATION WITH SECTION 1231.—

"(i) For purposes of paragraph (1)(B), adjusted gross income shall be determined without regard to the application of section 1231 to any gain or loss from an involuntary conversion of property described in subsection (c)(3) arising from fire, storm, shipwreck, or other casualty or from theft.

"(ii) Section 1231 shall be applied after the application of paragraph (1)."

(3) CLERICAL AMENDMENT.—Subsection (d) of section 6405 (relating to refunds attributable to certain disaster losses) is amended by striking out "section 165(h)" and inserting in lieu thereof "section 165(i)".

SEC. 612. TECHNICAL CORRECTIONS OF PROVISIONS PRIMARILY RELATING TO BUSINESSES.

(a) AMENDMENTS RELATED TO SECTION 204.—

(1) CLARIFICATION OF ADDITIONAL AMOUNT TREATED AS ORDINARY INCOME UNDER SECTION 1250.—

(A) Paragraph (1) of section 291(a) (relating to section 1250 capital gain treatment) is amended—

(i) by striking out "under section 1250" in subparagraph (B) and inserting in lieu thereof "under section 1250 (determined without regard to this paragraph)", and

(ii) by striking out "which is ordinary income" and inserting in lieu thereof "which is ordinary income under section 1250".

(B) Subsection (a) of section 1250 is amended by adding at the end thereof the following new paragraph:

"(4) CROSS REFERENCE.—

"For reduction in the case of corporations on capital gain treatment under this section, see section 291(a)(1)."

(2) INVESTMENT TAX CREDIT ALLOWED ONLY FOR MINERAL EXPLORATION AND DEVELOPMENT COSTS FOR DEPOSITS LOCATED IN THE UNITED STATES.—Clause (ii) of section 291(b)(2)(B) is amended by inserting "in the case of a deposit located in the United States," after "(ii)".

(3) CLARIFICATION OF COORDINATION WITH COST DEPLETION.—Paragraph (6) of section 291(b) (relating to coordination with cost depletion) is amended to read as follows:

"(6) COORDINATION WITH COST DEPLETION.—The portion of the adjusted basis of any property which is attributable to amounts to which paragraph (1) applied shall not be taken into account for purposes of determining depletion under section 611."

(4) CLARIFICATION OF DEFINITION OF INTEREST.—Subparagraph (B) of section 291(e)(1) (relating to interest on debt to carry tax-exempt obligations acquired after December 31, 1982) is amended by adding at the end thereof the following new clause:

"(iii) INTEREST.—For purposes of this subparagraph, the term 'interest' includes amounts (whether or not designated as interest) paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares."

(b) AMENDMENT RELATED TO SECTION 205.—Subsection (q) of section 48 (relating to basis adjustment to section 38 property) is amended by adding at the end thereof the following new paragraph:

"(6) ADJUSTMENT IN BASIS OF INTEREST IN PARTNERSHIP OR S CORPORATION.—The adjusted basis of—

"(A) a partner's interest in a partnership, and

"(B) stock in an S corporation,

shall be appropriately adjusted to take into account adjustments made under this subsection in the basis of property held by the partnership or S corporation (as the case may be)."

(c) AMENDMENT RELATED TO SECTION 207.—Paragraph (4) of section 189(e) (defining residential real property) is amended by striking out "or" at the end of subparagraph (A), by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", or", and by adding at the end thereof the following new subparagraph:

"(C) real property held by a cooperative housing corporation (as defined in section 216(b)) and used for dwelling purposes."

(d) AMENDMENTS RELATED TO SECTION 210.—

(1) SPECIAL RULE WHERE DEALER-LESSEE REQUIRED TO PURCHASE VEHICLE.—Paragraph (2) of section 210(b) of the Tax Equity and Fiscal Responsibility Act of 1982 (defining terminal rental adjustment clause) is amended by adding at the end thereof the following new sentence: "Such term also includes a provision of an agreement which requires a lessee who is a dealer in motor vehicles to purchase the motor vehicle for a predetermined price and then resell such vehicle where such provision achieves substantially the same results as a provision described in the preceding sentence."

(2) EXCEPTION WHERE LESSEE TOOK POSITION ON RETURN THAT HE WAS OWNER.—Section 210 of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by adding at the end thereof the following new subsection:

"(c) EXCEPTION WHERE LESSEE TOOK POSITION ON RETURN.—Subsection (a) shall not apply to deny a deduction for interest paid or accrued claimed by a lessee with respect to a qualified motor vehicle agreement on a return of tax imposed by chapter 1 of the Internal Revenue Code of 1954 which was filed before the date of the enactment of this Act or to deny a credit for investment in depreciable property claimed by the lessee on such a return pursuant to an agreement with the lessor that the lessor would not claim the credit."

(e) AMENDMENT RELATED TO SECTION 211.—Subparagraph (A) of section 211(e)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 (relating to retention of old sections 907(b) and 904(f)(4) where taxpayer had separate basket foreign loss) is amended by striking out "the 8-year period" and inserting in lieu thereof "the 8-year period (or such shorter period as the taxpayer may select)".

(f) AMENDMENT RELATED TO SECTION 212.—Paragraph (1) of section 954(h) (defining foreign base company oil-related income) is amended by striking out "section 907(c)(2)" and inserting in lieu thereof "paragraphs (2) and (3) of section 907(c)".

(g) AMENDMENT RELATED TO SECTION 213.—The table contained in subparagraph (C) of section 936(a)(2) is amended by striking out "The percentage tax is:" and inserting in lieu thereof "The percentage is:".

(h) AMENDMENT RELATED TO SECTION 217.—Subsection (e) of section 217 of the Tax Equity and Fiscal Responsibility Act of 1982 (relating to effective date) is amended by adding at the end thereof the following new sentence: "For purposes of applying section 168(f)(8)(D)(v) of the Internal Revenue Code of 1954, the amendments made by subsection (c) shall apply to agreements entered into after the date of the enactment of this Act."

(i) AMENDMENTS RELATED TO SECTION 222.—

(1) Sections 301(e)(2) and 302(f)(3) are each amended by striking out "partial or complete liquidation" and inserting in lieu thereof "complete liquidation".

(2) Paragraph (1) of section 543(a) (defining personal holding company income) is amended by striking out subparagraph (C), by adding "and" at the end of subparagraph (A), and by striking out ", and" at the end of subparagraph (B) and inserting in lieu thereof a period.

(j) AMENDMENT RELATED TO SECTION 223.—Paragraph (1) of section 311(e) (defining qualified stock) is amended by adding at the end thereof the following new subparagraph:

"(C) RULES FOR PASSTHRU ENTITIES.—In the case of an S corporation, partnership, trust, or estate—

"(i) the determination of whether subparagraph (A) is satisfied shall be made at the shareholder, partner, or beneficiary level (rather than at the entity level), and

"(ii) the distribution shall be treated as made directly to the shareholders, partners, or beneficiaries in proportion to their respective interests in the entity."

(k) AMENDMENTS RELATED TO SECTION 224.—

(1) DEFINITION OF PURCHASE.—

(A) Subparagraph (B) of section 338(h)(3) (defining purchase) is amended to read as follows:

"(B) DEEMED PURCHASE UNDER SUBSECTION (a).—The term 'purchase' includes any deemed purchase under subsection (a)(2)."

(B) Paragraph (3) of section 338(h) is amended by adding at the end thereof the following new subparagraph:

"(C) CERTAIN STOCK ACQUISITIONS FROM RELATED CORPORATIONS.—

"(i) IN GENERAL.—Clause (iii) of subparagraph (A) shall not apply to an acquisition of stock from a related corporation if at least 50 percent in value of the stock of such related corporation was acquired by purchase (within the meaning of subparagraphs (A) and (B)).

"(ii) CERTAIN DISTRIBUTIONS.—Clause (i) of subparagraph (A) shall not apply to an acquisition of stock described in clause (i) of this subparagraph if the corporation acquiring such stock—

"(I) made a qualified stock purchase of stock of the related corporation, and

"(II) made an election under this section (or is treated under subsection (e) as having made such an election) with respect to such qualified stock purchase.

"(iii) RELATED CORPORATION DEFINED.—For purposes of this subparagraph, a corporation is a related corporation if stock owned by such corporation is treated (under section 318(a) other than paragraph (4) thereof) as owned by the corporation acquiring the stock."

(C) Paragraph (1) of section 338(h) (defining 12-month acquisition period) is amended by inserting before the period at the end thereof the following: "(or, if any of such stock was acquired in an acquisition which is a purchase by reason of subparagraph (C) of paragraph (3), the date on which the acquiring corporation is first considered under section 318(a) (other than paragraph (4) thereof) as owning stock owned by the corporation from which such acquisition was made)".

(D) Paragraph (4) of section 318(b) (relating to cross references) is amended to read as follows: "(4) section 338(h)(3) (defining purchase);".

(2) SPECIAL RULES FOR APPLYING SECTION 338.—

(A) Subsection (h) of section 338 (relating to definitions and special rules) is amended by striking out paragraph (7), by redesignating paragraphs (8) and (9) as paragraphs (9) and (10), respectively, and by inserting after paragraph (6) the following new paragraphs:

"(7) ADDITIONAL PERCENTAGE MUST BE ATTRIBUTABLE TO PURCHASE, ETC.—For purposes of subsection (c)(1), any increase in the maximum percentage of stock taken into account over the percentage of stock (by value) of the target corporation held by the purchasing corporation on the acquisition date shall be taken into account only to the extent such increase is attributable to—

"(A) purchase, or

"(B) a redemption of stock of the target corporation—

"(i) to which section 302(a) applies, or

"(ii) in the case of a shareholder who is not a corporation, to which section 301 applies.

"(8) ACQUISITION BY AFFILIATED CORPORATIONS TAKEN INTO ACCOUNT FOR CONSISTENCY PURPOSES.—For purposes of subsections (e) and (f), except as otherwise provided in regulations, an affiliated group shall be treated as 1 corporation."

(B) Paragraph (9) of section 338(h), as redesignated by subparagraph (A), is amended by striking out "paragraph (9)" and inserting in lieu thereof "paragraph (10)".

(C) Subsection (h) of section 338 is amended by adding at the end thereof the following new paragraphs:

"(11) SECTION 337 TO APPLY WHERE TARGET HAD ADOPTED PLAN FOR COMPLETE LIQUIDATION.—If—

"(A) during the 12-month period ending on the acquisition date the target corporation adopted a plan of complete liquidation, "(B) such plan was not rescinded before the close of the acquisition date, and

"(C) the purchasing corporation makes an election under this section (or is treated under subsection (e) as having made such an election) with respect to the target corporation,

then, subject to rules similar to the rules of subsection (c)(1), for purposes of section 337 (and other provisions which relate to section 337), the target corporation shall be treated as having distributed all of its assets as of the close of the acquisition date.

"(12) TAX ON DEEMED SALE NOT TAKEN INTO ACCOUNT FOR ESTIMATED TAX PURPOSES.—For purposes of section 6655, tax attributable to the sale described in subsection (a)(1) shall not be taken into account.

"(13) COORDINATION WITH SECTION 341.—For purposes of determining whether section 341 applies to a disposition within 1 year after the acquisition date of stock by a shareholder (other than the acquiring corporation) who held stock in the target corporation on the acquisition date, section 341 shall be applied without regard to this section."

(3) COORDINATION WITH SECTION 333.—The last sentence of paragraph (1) of section 338(c) (relat-

ing to coordination with section 337 where purchasing corporation holds less than 100 percent of stock) is amended by striking out "such 1-year period" and inserting in lieu thereof "such 1-year period and section 333 does not apply to such liquidation".

(4) TREATMENT OF CERTAIN LIQUIDATIONS.—

(A) IN GENERAL.—Section 269 (relating to acquisitions made to evade or avoid income tax) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) CERTAIN LIQUIDATIONS AFTER QUALIFIED STOCK PURCHASES.—

"(1) IN GENERAL.—If—

"(A) there is a qualified stock purchase by a corporation of another corporation,

"(B) an election is not made under section 338 with respect to such purchase,

"(C) the acquired corporation is liquidated pursuant to a plan of liquidation adopted not more than 2 years after the acquisition date, and

"(D) the principal purpose for such liquidation is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which the acquiring corporation would not otherwise enjoy,

then the Secretary may disallow such deduction, credit, or other allowance.

"(2) MEANING OF TERMS.—For purposes of paragraph (1), the terms 'qualified stock purchase' and 'acquisition date' have the same respective meanings as when used in section 338."

(B) CONFORMING AMENDMENT.—Subsection (c) of section 269 (as redesignated by subparagraph (A)) is amended by striking out "subsection (a)" and inserting in lieu thereof "subsection (a) or (b)".

(C) EFFECTIVE DATE.—The amendments made by this paragraph shall apply to liquidations after October 20, 1983, in taxable years ending after such date.

(5) ASSETS TREATED AS SOLD AT FAIR MARKET VALUE.—

(A) Paragraph (1) of section 338(a) (relating to general rule) is amended by inserting "at fair market value" after "the acquisition date".

(B) Subsection (b) of section 338 (relating to price at which deemed sale made) is amended to read as follows:

"(b) BASIS OF ASSETS AFTER DEEMED PURCHASE.—

"(1) IN GENERAL.—For purposes of subsection (a), the assets of the target corporation shall be treated as purchased at an amount equal to their adjusted fair market value.

"(2) ADJUSTED FAIR MARKET VALUE.—For purposes of paragraph (1), the term 'adjusted fair market value' means the excess (if any) of—

"(A) the aggregate fair market value of the stock of the target corporation as of the close of the acquisition date, over

"(B) the amount of the net unrealized appreciation determined under paragraph (3).

"(3) AMOUNT OF NET UNREALIZED APPRECIATION.—For purposes of paragraph (2), the amount of the net unrealized appreciation determined under this paragraph is the excess (if any) of—

"(A) the fair market value of stock of the target corporation which is held by the purchasing corporation on the acquisition date, over

"(B) the aggregate bases of stock described in subparagraph (A).

"(4) ALLOCATION AMONG ASSETS.—The amount determined under paragraph (1) shall be allocated among the assets of the target corporation under regulations prescribed by the Secretary.

"(5) ADJUSTMENTS FOR CONTINGENT PAYMENTS, ETC.—Under regulations prescribed by the Secretary, proper adjustments shall be made in the application of this subsection and subsection (a) for contingent payments and other relevant items."

(6) TIME FOR MAKING ELECTION.—Paragraph (1) of section 338(g) (relating to election) is amended to read as follows:

"(1) WHEN MADE.—Except as otherwise provided in regulations, an election under this section shall be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs."

(7) REGULATORY AUTHORITY.—Subsection (i) of section 338 (relating to regulations) is amended to read as follows:

"(i) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section including—

"(1) regulations to ensure that the purposes of this section to require consistency of treatment of stock and asset purchases with respect to a target corporation and its target affiliates (whether by treating all of them as stock purchases or as asset purchases) may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations), and

"(2) regulations providing for the coordination of the provisions of this section with the provisions of this title relating to foreign corporations and their shareholders."

(8) AMENDMENTS NOT TO APPLY TO ACQUISITIONS BEFORE SEPTEMBER 1, 1982.—

(A) IN GENERAL.—The amendments made by this subsection shall not apply to any qualified stock purchase (as defined in section 338(d)(3) of the Internal Revenue Code of 1954) where the acquisition date (as defined in section 338(h)(2) of such Code) is before September 1, 1982.

(B) EXTENSION OF TIME FOR MAKING ELECTION.—In the case of qualified stock purchases involving the acquisition of 2 banks during February 1981, the time for making an election under section 338 of such Code shall not expire before the close of the 60th day after the date of the enactment of this Act.

(9) SPECIAL RULES FOR DEEMED PURCHASES UNDER PRIOR LAW.—If, before October 20, 1983, a

corporation was treated as making a qualified stock purchase (as defined in section 338(d)(3) of the Internal Revenue Code of 1954), but would not be so treated under the amendments made by paragraphs (1) and (2) of this subsection, such corporation may elect, at such time and in such manner as the Secretary of the Treasury or his delegate may by regulations prescribe, not to have the amendments made by such paragraphs apply.

(l) AMENDMENTS RELATED TO SECTION 226.—

(1) AMOUNT CONSTITUTING DIVIDEND.—Subparagraph (A) of section 304(b)(2) (relating to amount constituting dividend) is amended to read as follows:

"(A) WHERE SUBSECTION (a)(1) APPLIES.—In the case of any acquisition of stock to which paragraph (1) (and not paragraph (2)) of subsection (a) applies, the determination of the amount which is a dividend shall be made as if the property were distributed—

"(i) by the acquiring corporation to the extent of its earnings and profits, and

"(ii) then by the issuing corporation."

(2) COORDINATION WITH SECTION 351.—Subparagraph (A) of section 304(b)(3) (relating to coordination with section 351) is amended by striking out "(and

not part III)" and inserting in lieu thereof "(and not section 351 and not so much of sections 357 and 358 as relates to section 351)".

(3) CERTAIN ASSUMPTIONS OF LIABILITY.—

(A) The first sentence of clause (i) of section 304(b)(3)(B) (relating to certain assumptions of liability, etc.) is amended by striking out "Subsection (a)" and inserting in lieu thereof "In the case of an acquisition described in section 351, subsection (a)".

(B) Subparagraph (B) of section 304(b)(3) (relating to coordination with section 351) is amended by adding at the end thereof the following new clause:

"(iii) CLAUSE (i) DOES NOT APPLY TO STOCK ACQUIRED FROM RELATED PERSON EXCEPT WHERE COMPLETE TERMINATION.—Clause (i) shall apply only to stock acquired by the transferor from a person—

"(I) none of whose stock is attributable to the transferor under section 318(a) (other than paragraph (4) thereof), or

"(II) who satisfies rules similar to the rules of section 302(c)(2) with respect to both the acquiring and the issuing corporations (determined as if such person were a distributee of each such corporation)."

(4) DISTRIBUTIONS INCIDENT TO FORMATION OF BANK HOLDING COMPANIES.—Subparagraph (C) of section 304(b)(3) (relating to distributions incident to formation of bank holding companies) is amended by adding at the end thereof the following new sentence: "For purposes of this subparagraph, any assumption of (or acquisition of stock subject to) a liability under subparagraph (B) shall not be treated as a distribution of property."

(5) CONSTRUCTIVE OWNERSHIP.—

(A) Paragraph (3) of section 304(c) (relating to constructive ownership) is amended to read as follows:

"(3) CONSTRUCTIVE OWNERSHIP.—

"(A) IN GENERAL.—Section 318(a) (relating to constructive ownership of stock) shall apply for purposes of determining control under this section.

"(B) MODIFICATION OF 50-PERCENT LIMITATIONS IN SECTION 318.—For purposes of subparagraph (A)—

"(i) paragraph (2)(C) of section 318(a) shall be applied by substituting '5 percent' for '50 percent', and

"(ii) paragraph (3)(C) of section 318(a) shall be applied—

"(I) by substituting '5 percent' for '50 percent', and

"(II) in any case where such paragraph would not apply but for subclause (I), by considering a corporation as owning the stock (other than stock in such corporation) owned by or for any shareholder of such corporation in that proportion which the value of the stock which such shareholder owned in such corporation bears to the value of all stock in such corporation."

(B) Paragraph (4) of section 306(c) is amended by striking out the last sentence and inserting in lieu thereof the following: "For purposes of applying the preceding sentence to paragraph (3), the rules of section 304(c)(3)(B) shall apply."

(6) CERTAIN STOCK ACQUIRED IN SECTION 351 EXCHANGE.—Paragraph (3) of section 306(c) (relating to certain stock acquired in section 351 exchange) is

amended by striking out the last sentence and inserting in lieu thereof the following: "Rules similar to the rules of section 304(b)(2) shall apply—

"(A) for purposes of the preceding sentence, and

"(B) for purposes of determining the application of this section to any subsequent disposition of stock which is section 306 stock by reason of an exchange described in the preceding sentence."

(7) EFFECTIVE DATE FOR AMENDMENTS MADE BY PARAGRAPHS (1) AND (3).—The amendments made by paragraphs (1) and (3) shall apply to stock acquired after October 20, 1983, in taxable years ending after such date.

(m) AMENDMENT RELATED TO SECTION 229.—Subsection (c) of section 229 of the Tax Equity and Fiscal Responsibility Act of 1982 (relating to modification of regulations on the completed contract method of accounting) is amended by adding at the end thereof the following new paragraph:

"(4) UNDERPAYMENTS OF ESTIMATED TAX FOR 1982.—To the extent provided in regulations, no addition to tax shall be made under section 6654 or 6655 of the Internal Revenue Code of 1954 for the taxpayer's first taxable year ending after December 31, 1982, by reason of a long-term contract, but only with respect to installments required to be paid before April 13, 1983."

(n) AMENDMENT RELATED TO SECTION 233.—Paragraph (11) of section 51(d) (defining members of economically disadvantaged families) is amended by adding at the end thereof the following new sentence: "Any such determination with respect to an individual who is a qualified summer youth employee or youth participating in a qualified cooperative education program with respect to any employer shall also apply for purposes of determining whether such individual is a member of another targeted group with respect to such employer."

SEC. 613. TECHNICAL CORRECTIONS OF PENSION PROVISIONS.

(a) AMENDMENTS RELATED TO SECTION 235.—

(1) ACTUARIAL ADJUSTMENTS MADE TO BENEFIT LIMIT RATHER THAN TO BENEFIT.—

(A) Subparagraph (C) of section 415(b)(2) (relating to adjustment to $90,000 limit where benefit begins before age 62) is amended by striking out the first sentence and inserting in lieu thereof the following: "If the retirement income benefit under the plan begins before age 62, the determination as to whether the $90,000 limitation set forth in paragraph (1)(A) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by reducing the limitation of paragraph (1)(A) so that such limitation (as so reduced) equals an annual benefit (beginning when such retirement income benefit begins) which is equivalent to a $90,000 annual benefit beginning at age 62."

(B) Subparagraph (D) of section 415(b)(2) (relating to adjustment to $90,000 limitation where benefit begins after age 65) is amended to read as follows:

"(D) ADJUSTMENT TO $90,000 LIMIT WHERE BENEFIT BEGINS AFTER AGE 65.—If the retirement income benefit under the plan begins after age 65, the determination as to whether the $90,000 limitation set forth in paragraph (1)(A) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by increasing the limitation of paragraph (1)(A) so that such limitation (as so increased) equals an annual benefit (beginning when such retirement income benefit begins) which is equivalent to a $90,000 annual benefit beginning at age 65."

(C)(i) Clauses (i) and (iii) of section 415(b)(2)(E) are each amended by striking out "any benefit" and inserting in lieu thereof "any benefit or limitation".

(ii) Clause (ii) of section 415(b)(2)(E) is amended by striking out "any benefit" and inserting in lieu thereof "any limitation".

(2) DEFINITION OF CURRENT ACCRUED BENEFIT IN THE CASE OF COLLECTIVELY BARGAINED PLANS.—Clause (i) of section 235(g)(4)(B) of the Tax Equity and Fiscal Responsibility Act of 1982 (defining current accrued benefit) is amended by adding at the end thereof the following new sentence: "In the case of any plan described in the first sentence of paragraph (5), the preceding sentence shall be applied by substituting for 'January 1, 1983' the applicable date determined under paragraph (5)."

(3) TRANSITION FRACTION ONLY APPLIES TO PLANS IN EXISTENCE BEFORE JULY 1, 1982.—Paragraph (6) of section 415(e) (relating to special transition rule for defined contribution fraction for years ending after December 31, 1982) is amended by adding at the end thereof the following new subparagraph:

"(C) PLAN MUST HAVE BEEN IN EXISTENCE ON OR BEFORE JULY 1, 1982.—This paragraph shall apply only to plans which were in existence on or before July 1, 1982."

(4) TREATMENT OF CERTAIN COLLECTIVE BARGAINING AGREEMENTS ENTERED INTO BEFORE JULY 1, 1982.—Clause (ii) of section 235(g)(4)(B) of the Tax Equity and Fiscal Responsibility Act of 1982 (defining current accrued benefit) is amended by adding at the end thereof the following new sentence: "For purposes of subclause (I), any change in the terms and conditions of the plan pursuant to a collective bargaining agreement entered into before July 1, 1982, and ratified before September 3, 1982, shall be treated as a change made before July 1, 1982."

(b) AMENDMENTS RELATED TO SECTION 236.—

(1) EXCEPTION FOR CERTAIN LOANS NOT TO APPLY TO LOANS FROM DEDUCTIBLE EMPLOYEE CONTRIBUTIONS.—

(A) Subparagraph (A) of section 72(o)(3) (relating to amounts constructively received) is amended by striking out "subsection (p)" and inserting in lieu thereof "subsection (p) (other than the exception contained in paragraph (2) thereof)".

(B) Subparagraph (A) of section 72(p)(2) (relating to exception for certain loans) is amended by adding at the end thereof the following new sentence:

"For purposes of clause (ii), the present value of the nonforfeitable accrued benefit shall be determined without regard to any accumulated deductible employee contributions (as defined in subsection (o)(5)(B))."

(2) DEFINITION OF REQUIRED PRINCIPAL PAYMENT.—Subparagraph (C) of section 236(c)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by inserting before the period at the end thereof the following: "or if such loan was payable on demand".

(3) REPEAL OF PROVISION TREATING CERTAIN LOAN REPAYMENTS AS CONTRIBUTIONS.—Subsection (f) of section 404 (relating to certain loan repayments considered as contributions) is hereby repealed.

(4) CLARIFICATION OF EXCEPTION FOR SMALL LOANS.—Clause (ii) of section 72(p)(2)(A) (relating to exception for certain loans) is amended to read as follows:

"(ii) the greater of (I) one-half of the present value of the nonforfeitable accrued benefit of the employee under the plan, or (II) $10,000."

(c) AMENDMENTS RELATED TO SECTION 237.—

(1) AMENDMENTS CONFORMING TO LIMITING TO KEY EMPLOYEES THE PENALTY FOR PREMATURE DISTRIBUTIONS.—

(A) Clause (i) of section 72(m)(5)(A) is amended by striking out "as an owner-employee" and inserting in lieu thereof "as a key employee".

(B) The paragraph heading of section 72(m)(5) is amended by striking out "OWNER-EMPLOYEES" and inserting in lieu thereof "KEY EMPLOYEES".

(C) Sections 46(a)(4), 53(a), and 901(a) are each amended by striking out "tax on premature distributions to owner-employees" and inserting in lieu thereof "tax on premature distributions to key employees".

(2) CORRECTION OF CROSS REFERENCE TO DEFINITION OF BANK.—

(A) Subsection (f) of section 401 is amended by striking out "(as defined in subsection (d)(1))" and inserting in lieu thereof "(as defined in section 408(n))".

(B) Subsection (h) of section 408 is amended by striking out "(as defined in section 401(d)(1))" and inserting in lieu thereof "(as defined in subsection (n))".

(3) LIMITATION ON ROLLOVERS TO APPLY ONLY TO KEY EMPLOYEES.—Clause (ii) of section 402(a)(5)(E) (relating to self-employed individuals and owner-employees) is amended to read as follows:

"(ii) KEY EMPLOYEES.—An eligible retirement plan described in subclause (IV) or (V) of subparagraph (D)(iv) shall not be treated as an eligible retirement plan for the transfer of a distribution if any part of the distribution is attributable to contributions made on behalf of the employee while he was a key employee in a top-heavy plan. For purposes of the preceding sentence, the terms 'key employee' and 'top-heavy plan' have the same respective meanings as when used in section 416."

(d) AMENDMENTS RELATED TO SECTION 238.—

(1) REPEAL OF SECTION 72(m)(9).—Paragraph (9) of section 72(m) (relating to return of excess contributions before due date of return) is hereby repealed.

(2) INCREASE IN AMOUNT OF DEDUCTION FOR SIMPLIFIED EMPLOYEE PENSIONS.—Clause (ii) of section 219(b)(2)(A) (relating to special rules for employer

contributions under simplified employee pensions) is amended by striking out "but not in excess of $15,000" and inserting in lieu thereof "but not in excess of the limitation in effect under section 415(c)(1)(A)".

(3) REPEAL OF SECTION 401(e).—Subsection (e) of section 401 (relating to contributions for premiums on annuity, etc., contracts) is hereby repealed.

(4) REPEAL OF SECTION 404(a)(9).—

(A) Subsection (a) of section 404 is amended by striking out paragraph (9) and by redesignating paragraph (10) as paragraph (9).

(B) Subparagraph (C) of section 415(c)(6) is amended—

(i) by striking out "paragraph (10) of section 404(a)" and inserting in lieu thereof "paragraph (9) of section 404(a)",

(ii) by striking out "section 404(a)(10)(A)" and inserting in lieu thereof "section 404(a)(9)(A)", and

(iii) by striking out "section 404(a)(10)(B)" and inserting in lieu thereof "section 404(a)(9)(B)".

(5) REPEAL OF SECTION 404(h)(4).—Paragraph (4) of section 404(h) (relating to effect on self-employed individuals or shareholder employees) is hereby repealed.

(6) DETERMINATION OF EARNED INCOME OF SELF-EMPLOYED FOR PURPOSES OF SECTION 404(a)(8)(C).—Subparagraph (C) of section 404(a)(8) is amended by striking out "the earned income of such individual" and inserting in lieu thereof "the earned income of such individual (determined without regard to the deductions allowed by this section and section 405(c))".

(7) REPEAL OF SECTION 415(C)(7).—

(A) Subsection (c) of section 415 is amended by striking out paragraph (7) and by redesignating paragraph (8) as paragraph (7).

(B) Subclause (II) of section 415(e)(3)(B)(ii) is amended by striking out "subsection (c)(7) or (8)" and inserting in lieu thereof "subsection (c)(7)".

(8) COORDINATION OF REPEALS OF CERTAIN SECTIONS.—Sections 404(e) and 1379(b) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of the Tax Equity and Fiscal Responsibility Act of 1982) shall not apply to

any plan to which section 401(j) of such Code applies (or would apply but for its repeal).

(9) AMENDMENT OF SECTION 404(e).—Subsection (e) of section 404 is amended by striking out "under this section" and inserting in lieu thereof "under paragraph (1), (2), or (3) of subsection (a)".

(e) AMENDMENT RELATED TO SECTION 239.—Subparagraph (B) of section 101(b)(3) (relating to treatment of self-employed individuals for exclusion of employees' death benefits) is amended to read as follows:

"(B) SPECIAL RULE FOR CERTAIN DISTRIBUTIONS.—In the case of any amount paid or distributed—

"(i) by a trust described in section 401(a) which is exempt from tax under section 501(a), or

"(ii) under a plan described in section 403(a),

the term 'employee' includes a self-employed individual described in section 401(c)(1)."

(f) AMENDMENTS RELATED TO SECTION 240.—

(1) DEFINITION OF KEY EMPLOYEE.—

(A) Subparagraph (A) of section 416(i)(1) (defining key employee) is amended by striking out "any participant in an employer plan" and inserting in lieu thereof "an employee".

(B) Clause (ii) of section 416(i)(1)(A) is amended to read as follows:

"(ii) 1 of the 10 employees having annual compensation from the employer of more than the limitation in effect under section 415(c)(1)(A) and owning (or considered as owning within the meaning of section 318) the largest interests in the employer,".

(C) Subparagraph (A) of section 416(i)(1) (defining key employee) is amended by adding at the end thereof the following new sentence: "For purposes of clause (ii), if 2 employees have the same interest in the employer, the employee having greater annual compensation from the employer shall be treated as having a larger interest."

(D) Subparagraph (C) of section 416(i)(1) is amended by striking out "DETERMINING 5-PERCENT OR 1-PERCENT OWNERS" in the subparagraph heading and inserting in lieu thereof "DETERMINING OWNERSHIP IN THE EMPLOYER".

(2) TREATMENT OF SIMPLIFIED EMPLOYEE PENSIONS.—Paragraph (1) of section 408(k) (defining

simplified employee pension) is amended to read as follows:

"(1) IN GENERAL.—For purposes of this title, the term 'simplified employee pension' means an individual retirement account or individual retirement annuity—

"(A) with respect to which the requirements of paragraphs (2), (3), (4), and (5) of this subsection are met, and

"(B) if such account or annuity is part of a top-heavy plan (as defined in section 416), with respect to which the requirements of section 416(c)(2) are met."

(3) CLARIFICATION OF TRANSITIONAL RULE.—Paragraph (3) of section 235(g) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by adding at the end thereof the following new sentence: "A similar rule shall apply with respect to the last plan year beginning before January 1, 1984, for purposes of applying section 416(h) of the Internal Revenue Code of 1954."

(4) TREATMENT OF DISTRIBUTIONS FROM TERMINATED PLANS.—Paragraph (3) of section 416(g) (relating to distributions during last 5 years taken into account) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall

also apply to distributions under a terminated plan which if it had not been terminated would have been required to be included in an aggregation group."

(5) CLARIFICATION OF COST-OF-LIVING ADJUSTMENTS.—

(A) IN GENERAL.—Paragraph (2) of section 416(d) (relating to cost-of-living adjustments) is amended by striking out "in the same manner" and inserting in lieu thereof "at the same time and in the same manner".

(B) SIMPLIFIED EMPLOYEE PENSIONS.—Subparagraph (C) of section 408(k)(3) (relating to contributions must bear uniform relationship to total compensation) is amended by adding at the end thereof the following new sentence: "The Secretary shall annually adjust the $200,000 amount contained in the preceding sentence at the same time and in the same manner as he adjusts the dollar amount contained in section 415(c)(1)(A)."

(6) CLERICAL AMENDMENTS.—

(A) Subsection (f) of section 416 is amended by striking out "require" and inserting in lieu thereof "required".

(B) Clause (iii) of section 416(i)(1)(B) is amended by striking out "subparagraph (A)(ii)(II)" and inserting in lieu thereof "subparagraph (A)(ii)".

(g) AMENDMENTS RELATED TO SECTION 242.—

(1) DEFINITION OF KEY EMPLOYEE AND TOP-HEAVY PLAN.—

(A) Clause (i) of section 401(a)(9)(A) (relating to required distributions before death) is amended to read as follows:

"(i) either will be distributed to him not later than the later of—

"(I) his taxable year in which he attains age 70½, or

"(II) his taxable year in which he retires, or".

(B) Subparagraph (A) of section 401(a)(9) is amended by adding at the end thereof the following new sentence: "Subclause (II) of clause (i) shall not apply with respect to any employee who was a key employee (as defined in section 416) in a top-heavy plan (as defined in section 416) for the plan year ending in the taxable year in which he attains age 70½."

(2) EXCEPTION FOR CERTAIN DEPENDENTS OR FORMER SPOUSE.—Paragraph (9) of section 401(a) is amended by added at the end thereof the following new subparagraphs:

"(C) EXCEPTION WHERE DISTRIBUTIONS MADE TO CERTAIN DEPENDENTS OR FORMER SPOUSE.—Subparagraph (B) shall not apply if the entire interest of the employee (or the remaining part of such interest if distribution thereof has commenced) will be distributed (beginning not later than 1 year after the employee's death or the death of his surviving spouse)—

"(i) to a qualified beneficiary, and

"(ii) in accordance with regulations prescribed by the Secretary, over a qualified period.

"(D) QUALIFIED BENEFICIARY DEFINED.—For purposes of subparagraph (C), the term 'qualified beneficiary' means—

"(i) any qualified dependent, and

"(ii) a former spouse of the employee.

"(E) QUALIFIED DEPENDENT.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'qualified dependent' means any individual who was a dependent (as defined in section 152) of the employee (or his surviving spouse) for any 2 of the last 5 taxable years of the employee (or his surviving spouse).

"(ii) SPECIAL RULE FOR CHILD OF DIVORCED PARENTS, ETC.—Any child to whom section 152(e) applies for any taxable year shall be treated as the dependent of both parents.

"(iii) SOCIAL SECURITY BENEFITS DISREGARDED.—Benefits under title II of the Social Security Act received by (or on behalf of) an individual shall not be taken into account for purposes of determining whether such individual is the dependent of another taxpayer.

"(F) QUALIFIED PERIOD.—For purposes of this paragraph—

"(i) IN GENERAL.—The qualified period with respect to any qualified beneficiary shall end at the later of—

"(I) the life expectancy of an individual with an age equal to the age of the employee at his death (or the age of the surviving spouse), or

"(II) 5 years after the date of the employee's death (or the death of the surviving spouse).

"(ii) SPECIAL RULE FOR PERMANENTLY AND TOTALLY DISABLED INDIVIDUALS.—In accordance with regulations, the qualified period for any individual who was permanently and totally disabled at the death of the employee (or who thereafter becomes permanently and totally disabled) shall be the life of such individual or a term certain not extending beyond the life expectancy of such individual.

"(G) SPECIAL RULES FOR MINORS.—For purposes of this paragraph, in the case of an individual who has not attained age 22 at the time of the employee's death—

"(i) the distributions are not required to begin before the individual attains age 22, and

"(ii) the qualified period shall in no case end before such individual attains age 27."

(3) CLARIFICATION OF TRANSITIONAL RULE.—

(A) Subparagraph (B) of section 242(b)(2) of the Tax Equity and Fiscal Responsibility Act of

1982 is amended by striking out "paragraph (9) of".

(B) Paragraph (2) of section 242(b) of such Act is amended by striking out "January 1, 1984" and inserting in lieu thereof "the first day of the first plan year beginning on or after January 1, 1984".

(C) Subsection (b) of section 242 of such Act is amended by adding at the end thereof the following new paragraph:

"(3) TREATMENT OF CERTAIN DEFAULT OPTIONS.—For purposes of paragraph (2), if—

"(A) a plan permits an employee to designate a method of distribution but provides that in the absence of such a designation a specified method of distribution will apply, and

"(B) as of the first day of the first plan year beginning on or after January 1, 1984, such specified method of distribution applied to an individual by reason of his failure to make a designation which was available to him before such first day,

such specified method of distribution shall be treated as pursuant to a designation made by the employee before the first day of such plan year."

(4) SPECIAL RULE FOR COLLECTIVE-BARGAINING AGREEMENTS.—Paragraph (5) of section 235(g) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended—

(A) by striking out "section 253" each place it appears and inserting in lieu thereof "section 242", and

(B) by adding at the end thereof the following new sentence: "In the case of any plan described in the first sentence of this paragraph, paragraphs (2) and (3) of section 242(b) shall be applied by substituting for 'January 1, 1984' the applicable date determined under this paragraph."

(5) CLARIFICATION THAT REQUIRED DISTRIBUTIONS MAY BE MADE TO OTHER BENEFICIARIES.—Clause (ii) of section 401(a)(9)(A) is amended by inserting "to the employee or any of his beneficiaries" after "will be distributed".

(6) DELAY IN EFFECTIVE DATE FOR GOVERNMENT PLANS.—Subsection (b) of section 242 of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by adding at the end thereof the following new paragraph:

"(4) SPECIAL RULE FOR GOVERNMENT PLANS.—In the case of a government plan (as defined in section 414(d) of the Internal Revenue Code of 1954)—

"(A) paragraph (1) shall be applied by substituting 'December 31, 1985' for 'December 31, 1983', and

"(B) paragraphs (2) and (3) shall be applied by substituting 'January 1, 1986' for 'January 1, 1984'."

(h) AMENDMENTS RELATED TO SECTION 243.—

(1) EFFECTIVE DATE FOR PROVISIONS RELATED TO INHERITED INDIVIDUAL RETIREMENT PLANS.—Subsection (c) of section 243 of the Tax Equity and Fiscal Responsibility Act of 1982 is amended to read as follows:

"(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to individuals dying after December 31, 1983."

(2) CLERICAL AMENDMENT.—The subparagraph (C) of section 408(d)(3) which was added by section 335(a)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 is redesignated as subparagraph (D).

(i) AMENDMENT RELATED TO SECTION 247.—Subsection (a) of section 247 of the Tax Equity and Fiscal Responsibility Act of 1982 (relating to existing personal service corporations may liquidate under section 333 during 1983 and 1984) is amended by inserting "which is in existence on September 3, 1982," after "section 535(c)(2)(B) of the Internal Revenue Code of 1954)".

(j) AMENDMENT RELATED TO SECTION 248.—Paragraph (2) of section 414(n) (defining leased employee) is amended by striking out "any person" in the material preceding subparagraph (A) and inserting in lieu thereof "any person who is not an employee of the recipient and".

(k) AMENDMENT RELATED TO SECTION 249.—Subparagraph (D) of section 408(k)(3) (relating to treatment of certain contributions and taxes) is amended by striking out the second and third sentences and inserting in lieu thereof the following: "If the employer does not maintain an integrated plan at any time during the taxable year, OASDI contributions (as defined in section 401(l)(2)) may, for purposes of this paragraph, be taken into account as contributions by the employer to the employee's simplified employee pension, but only if such contributions are so taken into account with respect to each employee maintaining a simplified employee pension."

(l) AMENDMENTS RELATED TO SECTION 253.—

(1) LIMITATION OF PROFIT-SHARING AND STOCK BONUS PLANS.—Subparagraph (C) of section 415(c)(3) is amended by striking out "In the case of a partici-

pant" and inserting in lieu thereof "In the case of a participant in a profit-sharing or stock bonus plan".

(2) CLARIFICATION OF RULE THAT CONTRIBUTIONS BE NONFORFEITABLE.—Subparagraph (C) of section 415(c)(3) (relating to special rules for permanent and total disability) is amended by striking out the last sentence and inserting in lieu thereof the following: "This subparagraph shall apply only if contributions made with respect to amounts treated as compensation under this subparagraph are nonforfeitable when made."

SEC. 614. MISCELLANEOUS PROVISIONS.

(a) AMENDMENT RELATED TO SECTION 255.—Subsection (c) of section 811 (relating to special rule for dividends to policyholders under reinsurance contracts) is amended by striking out "conventional coinsurance contract" and inserting in lieu thereof "reinsurance contract".

(b) AMENDMENT RELATED TO SECTION 281A.—Paragraph (2) of section 281A(b) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended by striking out "subsection (a)" and inserting in lieu thereof "paragraph (1)".

(c) AMENDMENT RELATED TO SECTION 292.—Paragraph (2) of section 7430(a) (relating to awarding of court costs and certain fees) is amended by striking out "including the Tax Court" and inserting in lieu thereof "including the Tax Court and the United States Claims Court".

(d) AMENDMENT RELATED TO SECTION 314.—Subparagraph (E) of section 6678(3) is amended by striking out "section 6053(c)" and inserting in lieu thereof "section 6053".

(e) AMENDMENTS RELATED TO SECTION 323.—

(1) Subsection (b) of section 5684 is amended—

(A) by striking out "SECTION 6660" in the heading and inserting in lieu thereof "SECTION 6662", and

(B) by striking out "section 6660(a)" in the text and inserting in lieu thereof "section 6662(a)".

(2) Subsection (c) of section 5761 is amended—

(A) by striking out "SECTION 6660" in the heading and inserting in lieu thereof "SECTION 6662", and

(B) by striking out "section 6660(a)" in the text and inserting in lieu thereof "section 6662(a)".

(f) AMENDMENTS RELATED TO SECTION 334.—

(1) CLARIFICATION THAT DEATH BENEFIT EXCLUSION APPLIES TO DISTRIBUTIONS UNDER SECTION 403(b).—Subparagraph (C) of section 3405(b)(2)

(relating to special rule for distributions by reason of death) is amended to read as follows:

"(C) SPECIAL RULE FOR DISTRIBUTIONS BY REASON OF DEATH.—In the case of any nonperiodic distribution from or under any plan or contract described in section 401(a), 403(a), or 403(b)—

"(i) which is made by reason of a participant's death, and

"(ii) with respect to which the requirements of clauses (ii) and (iv) of subsection (d)(4)(A) are met,

subparagraph (A) or (B) (as the case may be) shall be applied by taking into account the exclusion from gross income provided by section 101(b) (whether or not allowable)."

(2) CLARIFICATION OF CREDIT FOR WITHHELD AMOUNTS.—Paragraph (1) of section 31(a) is amended by striking out "under section 3402 as tax on the wages of any individual" and inserting in lieu thereof "as tax under chapter 24".

(3) PENALTY FOR FAILURE TO GIVE NOTICE.—Section 6652 (relating to penalty for failure to file certain information returns, registration statements, etc.) is amended by redesignating subsection (i) as subsec-

tion (j) and by inserting after subsection (h) the following new subsection:

"(i) FAILURE TO GIVE NOTICE TO RECIPIENTS OF CERTAIN PENSION, ETC., DISTRIBUTIONS.—In the case of each failure to provide notice as required by section 3405(d)(10)(B), at the time prescribed therefor, unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid, on notice and demand of the Secretary and in the same manner as tax, by the person failing to provide such notice, an amount equal to $10 for each such failure, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $5,000."

(4) EXCEPTION FOR AMOUNTS PAID TO NONRESIDENT ALIENS.—Subparagraph (B) of section 3405(d)(1) (relating to exceptions) is amended by striking out "and" at the end of clause (i), by striking out the period at the end of clause (ii) and inserting in lieu thereof ", and", and by adding at the end thereof the following new clause:

"(iii) any amount which is subject to withholding under subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and foreign corporations) by the person paying such amount or which would be so subject but for a tax treaty."

(5) CLARIFICATION OF AMOUNT WITHHELD WHERE EMPLOYER SECURITY DISTRIBUTED.—Paragraph (8) of section 3405(d) (relating to maximum amount withheld) is amended by adding at the end thereof the following new sentence: "No amount shall be required to be withheld under this section in the case of any designated distribution which consists only of employer securities of the employer corporation (within the meaning of section 402(a)(3)) and cash (not in excess of $200) in lieu of fractional shares."

(g) AMENDMENT RELATED TO SECTION 337.—Subsection (d) of section 982 (relating to admissibility of documentation maintained in foreign countries) is amended by striking out paragraph (3) and by redesignating paragraph (4) as paragraph (3).

(h) AMENDMENT RELATED TO SECTION 339.—Paragraph (1) of section 6038A(c) (defining control) is amended by striking out "section 6038(d)(1)" and inserting in lieu thereof "section 6038(e)(1)".

(i) AMENDMENT RELATED TO SECTION 345.—Subsection (b) of section 345 of the Tax Equity and Fiscal Responsibility Act of 1982 (relating to effective date) is amended by striking out "taking effect on" and inserting in lieu thereof "taking effect on or after".

(j) AMENDMENT RELATED TO SECTION 346.—Subparagraph (B) of section 346(c)(2) of the Tax Equity and Fiscal Responsibility Act of 1982 is amended to read as follows:

"(B) Subparagraph (A) of section 6601(d)(2) is amended by striking out 'the last day of' each place it appears and inserting in lieu thereof 'the filing date for'."

(k) AMENDMENTS RELATED TO TITLE IV.—

(1) EXTENSION OF PARTNERSHIP AUDIT PROVISIONS TO ENTITIES FILING PARTNERSHIP RETURNS, ETC.—Subchapter C of chapter 63 (relating to tax treatment of partnership items) is amended by adding at the end thereof the following new section:

"SEC. 6233. EXTENSION TO ENTITIES FILING PARTNERSHIP RETURNS, ETC.

"(a) GENERAL RULE.—If a partnership return is filed by an entity for a taxable year but it is determined that the entity is not a partnership for such year, then, to the extent provided in regulations, the provisions of this subchapter are hereby extended in respect of such year to such entity and its items and to persons holding an interest in such entity.

"(b) SIMILAR RULES IN CERTAIN CASES.—If for any taxable year—

"(1) an entity files a return as an S corporation but it is determined that the entity was not an S corporation for such year, or

"(2) a partnership return or S corporation return is filed but it is determined that there is no entity for such taxable year,

then, to the extent provided in regulations, rules similar to the rules of subsection (a) shall apply."

(2) TECHNICAL AND CLERICAL AMENDMENTS.—

(A) Subparagraph (B) of section 6230(c)(1) is amended by striking out "(or erroneously computed the amount of any such credit or refund)".

(B) Paragraph (9) of section 6231(a) is amended by striking out "electing small business corporation" and inserting in lieu thereof "S corporation".

(C) Subsection (f) of section 6231 is amended by striking out "such deduction or credit" and inserting in lieu thereof "such loss or credit".

(D) The table of sections for subpart C of chapter 63 is amended by adding at the end thereof the following new item:

"Sec. 6233. Extension to entities filing partnership returns, etc."

(E) Paragraph (3) of section 6501(q) is amended to read as follows:

"(3) CROSS REFERENCE.—

"For extension of period for windfall profit tax items of partnerships, see section 6229 as made applicable by section 6232."

(F) Paragraph (3) of section 6511(h) is amended to read as follows:

"(3) CROSS REFERENCE.—

"For period of limitation for windfall profit tax items of partnerships, see section 6227(a) and subsections (c) and (d) of section 6230 as made applicable by section 6232."

(G) Subsection (h) of section 7422 is amended by striking out "section 6131(a)(3)" and inserting in lieu thereof "section 6231(a)(3)".

(H) Subparagraph (B) of section 6231(b)(2) (relating to items cease to be partnership items in certain cases) is amended by striking out "section 6227(b)" and inserting in lieu thereof "section 6227(c)".

SEC 615. EFFECTIVE DATE.

Any amendment made by this subtitle shall take effect as if included in the provision of the Tax Equity and Fiscal Responsibility Act of 1982 to which such amendment relates.

Subtitle B—Amendments Related to Subchapter S Revision Act of 1982; Etc.

SEC. 621. TECHNICAL CORRECTIONS OF SUBCHAPTER S REVISION ACT OF 1982.

(a) LIMITATION ON RECOGNITION OF GAIN IN THE CASE OF CERTAIN DISTRIBUTIONS.—

(1) Section 1363 (relating to effect of election on corporation) is amended by adding at the end thereof the following new subsection:

"(e) SUBSECTION (d) NOT TO APPLY TO COMPLETE LIQUIDATIONS AND REORGANIZATIONS.—Subsection (d) shall not apply to any distribution—

"(1) of property in complete liquidation of the corporation, or

"(2) to the extent it consists of property permitted by section 354, 355, or 356 to be received without the recognition of gain."

(2) Subsection (d) of section 1363 is amended by striking out "If" and inserting in lieu thereof "Except as provided in subsection (e), if".

(b) COORDINATION WITH RULES RELATING TO INCOME FROM DISCHARGE OF INDEBTEDNESS.—

(1) Paragraph (2) of section 1363(c) (relating to elections of the S corporation) is amended by striking

out subparagraph (A) and by redesignating subparagraphs (B), (C), and (D) as subparagraphs (A), (B), and (C), respectively.

(2) Subsection (d) of section 108 (relating to income from discharge of indebtedness) is amended by redesignating paragraphs (7), (8), and (9) as paragraphs (8), (9), and (10), respectively, by striking out paragraph (6), and by inserting after paragraph (5) the following new paragraphs:

"(6) SUBSECTIONS (a), (b), AND (c) TO BE APPLIED AT PARTNER LEVEL.—In the case of a partnership, subsections (a), (b), and (c) shall be applied at the partner level.

"(7) SPECIAL RULES FOR S CORPORATION.—

"(A) SUBSECTIONS (a), (b), AND (c) TO BE APPLIED AT CORPORATE LEVEL.—In the case of an S corporation, subsections (a), (b), and (c) shall be applied at the corporate level.

"(B) REDUCTION IN CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS.—In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year.

"(C) COORDINATION WITH BASIS ADJUSTMENTS UNDER SECTION 1367(b)(2).—For purposes of subsection (e)(6), a shareholder's adjusted basis in indebtedness of an S corporation shall be determined without regard to any adjustments made under section 1367(b)(2)."

(c) TREATMENT OF INACTIVE SUBSIDIARIES.—Paragraph (6) of section 1361(c) (relating to ownership of stock in certain inactive corporations) is amended to read as follows:

"(6) OWNERSHIP OF STOCK IN CERTAIN INACTIVE CORPORATIONS.—For purposes of subsection (b)(2)(A), a corporation shall not be treated as a member of an affiliated group during any period within a taxable year by reason of the ownership of stock in another corporation if such other corporation—

"(A) has not begun business at any time on or before the close of such period, and

"(B) does not have gross income for such period."

(d) TREATMENT OF WORTHLESS DEBT.—Paragraph (3) of section 1367(b) (relating to coordination with section 165(g)) is amended to read as follows:

"(3) COORDINATION WITH SECTIONS 165(g) AND 166(d).—This section and section 1366 shall be applied before the application of sections 165(g) and 166(d) to any taxable year of the shareholder or the corporation in which the security or debt becomes worthless."

(e) ADJUSTMENT TO EARNINGS AND PROFITS FOR RECAPTURE UNDER SECTION 47.—

(1) Subsection (d) of section 1371 (relating to coordination with investment credit recapture) is amended by adding at the end thereof the following new paragraph:

"(3) ADJUSTMENT TO EARNINGS AND PROFITS FOR AMOUNT OF RECAPTURE.—Paragraph (1) of subsection (c) shall not apply to any increase in tax under section 47 for which the S corporation is liable."

(2) Paragraph (1) of section 1371(c) is amended by striking out "paragraphs (2) and (3)" and inserting in lieu thereof "paragraphs (2) and (3) and subsection (d)(3)".

(f) QUALIFIED SUBCHAPTER S TRUSTS.—

(1) GRACE PERIOD.—Subparagraph (D) of section 1361(d)(2) (relating to grace period) is amended by striking out "60 days" and inserting in lieu thereof "75 days".

(2) DEFINITION OF QUALIFIED SUBCHAPTER S TRUST.—Subsection (d) of section 1361 (relating to special rule for qualified subchapter S trust) is amended

by striking out paragraphs (3) and (4) and inserting in lieu thereof the following:

"(3) QUALIFIED SUBCHAPTER S TRUST.—For purposes of this subsection, the term 'qualified subchapter S trust' means a trust—

"(A) the terms of which require that—

"(i) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust,

"(ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary,

"(iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and

"(iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary, and

"(B) all of the income (within the meaning of section 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

"(4) TRUST CEASING TO BE QUAL

"(A) FAILURE TO MEET REQUIREMENTS OF PARAGRAPH (3)(A).—If a qualified subchapter S trust ceases to meet any requirement of paragraph (3)(A), the provisions of this subsection shall not apply to such trust as of the date it ceases to meet such requirement.

"(B) FAILURE TO MEET REQUIREMENTS OF PARAGRAPH (3)(B).—If any qualified subchapter S trust ceases to meet any requirement of paragraph (3)(B) but continues to meet the requirerments of paragraph (3)(A), the provisions of this subsection shall not apply to such trust as of the first day of the first taxable year beginning after the first taxable year for which it failed to meet the requirements of paragraph (3)(B)."

(3) TECHNICAL AMENDMENT.—Clause (i) of section 1361(d)(2)(B) (relating to separate election with respect to each S corporation) is amended by striking out "S corporation" each place it appears and inserting in lieu thereof "corporation".

(g) COORDINATION WITH SECTION 338.—

(1) Paragraph (6) of section 1362(e) (relating to treatment of S termination year) is amended by adding at the end thereof the following new subparagraph:

"(C) PARAGRAPH (2) NOT TO APPLY TO ITEMS RESULTING FROM SECTION 338.—Paragraph (2) shall not apply with respect to any item resulting from the application of section 338."

(2) Paragraph (2) of section 1362(e) is amended by striking out "as provided in paragraph (3)" and inserting in lieu thereof "as provided in paragraphs (3) and (6)(C)".

(h) ELECTION TO HAVE ITEMS ASSIGNED TO SHORT TAXABLE YEAR UNDER NORMAL ACCOUNTING RULES.—Subparagraph (B) of section 1362(e)(3) (relating to election to have items assigned to each short taxable year under normal accounting rules) is amended to read as follows:

"(B) SHAREHOLDERS MUST CONSENT TO ELECTION.—An election under this subsection shall be valid only if all persons who are shareholders in the corporation at any time during the S short year and all persons who are shareholders in the corporation on the first day of the C short year consent to such election."

(i) ELECTION TO HAVE NEW PASSIVE INCOME RULES NOT APPLY DURING 1982.—Paragraph (3) of section 6(b) of the Subchapter S Revision Act of 1982 (relating to new passive income rules apply to taxable years beginning during 1982) is amended by adding at the end thereof the following new sentences: "The preceding sentence shall not apply in the case of any corporation which elects (at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe) to have such sentence not apply. Subsection (e) shall not apply to any termination resulting from an election under the preceding sentence."

(j) S CORPORATION TREATED AS PARTNERSHIP FOR PURPOSES OF SECTION 318.—Paragraph (5) of section 318(a) (relating to constructive ownership of stock) is amended by adding at the end thereof the following new subparagraphs:

"(E) S CORPORATION TREATED AS PARTNERSHIP.—For purposes of this subsection—

"(i) an S corporation shall be treated as a partnership, and

"(ii) any shareholder of the S corporation shall be treated as a partner of such partnership.

The preceding sentence shall not apply for purposes of determining whether stock in the S corporation is constructively owned by any person."

(k) CLARIFICATION OF TREATMENT OF CERTAIN ELECTIONS UNDER PRIOR LAW.—Subsection (e) of section 6 of the Subchapter S Revision Act of 1982 (relating to treatment of certain elections under prior law) is amended by striking out "any termination" and inserting in lieu thereof "any termination or revocation".

(l) ELECTIONS FOR CERTAIN SHORT TAXABLE YEARS.—Subsection (b) of section 1362 (relating to when subchapter S election made) is amended by adding at the end thereof the following new paragraph:

"(4) TAXABLE YEARS OF 2½ MONTHS OR LESS.—For purposes of this subsection, an election for a taxable year made not later than 2 months and 15 days after the first day of the taxable year shall be treated as timely made during such year."

(m) TAXABLE YEAR OF EXISTING S CORPORATIONS.—Paragraph (1) of section 1378(c) (relating to existing S corporations required to use permitted year after 50-percent shift in ownership) is amended by striking out "which includes December 31, 1982" and inserting in lieu thereof "which includes December 31, 1982 (or which is an S corporation for a taxable year beginning during 1983 by reason of an election made on or before October 19, 1982)".

(n) REFERENCES TO PRIOR LAW.—Subsection (b) of section 1379 (relating to references to prior law included) is amended to read as follows:

"(b) REFERENCES TO PRIOR LAW INCLUDED.—Any references in this title to a provision of this subchapter shall, to the extent not inconsistent with the purposes of this subchapter, include a reference to the corresponding provision as in effect before the enactment of the Subchapter S Revision Act of 1982."

(o) ELECTION TO TREAT DISTRIBUTIONS AS DIVIDENDS DURING CERTAIN POST-TERMINATION TRANSITION PERIODS.—Subsection (e) of section 1371 (relating to coordination with subchapter C) is amended to read as follows:

"(e) CASH DISTRIBUTIONS DURING POST-TERMINATION TRANSITION PERIOD.—

"(1) IN GENERAL.—Any distribution of money by a corporation with respect to its stock during a post-termination transition period shall be applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed the accumulated adjustments account.

"(2) ELECTION TO DISTRIBUTE EARNINGS FIRST.—An S corporation may elect to have paragraph (1) not apply to all distributions made during a post-termination transition period described in section 1377(b)(1)(A). Such election shall not be effective unless all shareholders of the S corporation to whom distributions are made by the S corporation during such post-termination transition period consent to such election."

(p) CORPORATE PREFERENCE RULES APPLIED TO S CORPORATIONS WHICH WERE RECENT C CORPORATIONS.—Subsection (b) of section 1363 (relating to computation of corporation's taxable income) is amended by striking out "and" at the end of paragraph (2), by striking out the period at the end of paragraph (3) and inserting in lieu thereof ", and", and by adding at the end thereof the following new paragraph:

"(4) section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years."

(q) TREATMENT OF STOCK HELD BY ESTATE OF QUALIFIED TRANSFEROR.—Clause (i) of section 1378(c)(3)(B) (relating to existing S corporations required to use permitted year after 50-percent shift in ownership) is amended by striking out "who held" and inserting in lieu thereof "who (or whose estate) held".

(r) AMENDMENTS RELATED TO ACCUMULATED ADJUSTMENTS ACCOUNT.—

(1) Subparagraph (A) of section 1368(e)(1) (defining accumulated adjustments account) is amended by striking out "(except that" and all that follows through the end thereof and inserting in lieu thereof the following: "(except that no adjustment shall be made for income (and related expenses) which is exempt from

tax under this title and the phrase '(but not below zero)' shall be disregarded in section 1367(b)(2)(A))".

(2) Subsection (c) of section 1368 (relating to S corporation having earning and profits) is amended by adding at the end thereof the following new sentence: "If the distributions during the taxable year exceed the amount in the accumulated adjustments account at the close of the taxable year, for purposes of this subsection, the balance of such account shall be allocated among such distributions in proportion to their respective sizes."

(s) SPECIAL RULES FOR CERTAIN EXPENSES OF S CORPORATIONS.—Paragraph (1) of section 267(f) (as in effect on the day before the date of the enactment of this Act) is amended by striking out all that follows subparagraph (B) and inserting in lieu thereof the following: "then any deduction allowable under such sections in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph)."

(t) PRO RATA ALLOCATION FOR S TERMINATION YEAR NOT TO APPLY IF 50-PERCENT CHANGE IN OWNERSHIP.—Paragraph (6) of section 1362(e) (relating to special rules) is amended by adding at the end thereof the following new subparagraph:

"(C) PRO RATA ALLOCATION FOR S TERMINATION YEAR NOT TO APPLY IF 50-PERCENT CHANGE IN OWNERSHIP.—Paragraph (2) shall not apply to an S termination year if there is a sale or exchange of 50 percent or more of the stock in such corporation during such year."

(u) CLERICAL AMENDMENTS.—

(1) Subparagraph (B) of section 465(a)(1) (relating to limitation to amount at risk) is amended by striking out "a corporation" and inserting in lieu thereof "a C corporation".

(2) Subsection (e) of section 1371 (relating to cash distributions during post-termination transition period) is amended by inserting before the period at the end thereof the following: "(within the meaning of section 1368(e))".

(3) Paragraph (2) of section 6659(f) is amended by striking out "section 465(a)(1)(C)" and inserting in lieu thereof "section 465(a)(1)(B)".

(4) Subparagraph (C) of section 6362(d)(2) is amended by striking out "electing small business corporation (within the meaning of section 1371(a))" and inserting in lieu thereof "an S corporation".

(v) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), any amendment made by this section shall take effect as if included in the Subchapter S Revision Act of 1982.

(2) AMENDMENT MADE BY SUBSECTION (b)(2).—Subparagraph (C) of section 108(d)(7) of the Internal Revenue Code of 1954 (as amended by subsection (b)(2)) shall apply to contributions to capital after December 31, 1980, in taxable years ending after such date.

(3) AMENDMENT MADE BY SUBSECTION (g)(1).—If—

(A) any portion of a qualified stock purchase is pursuant to a binding contract entered into on or after October 19, 1982, and before the date of the enactment of this Act, and

(B) the purchasing corporation establishes by clear and convincing evidence that such contract was negotiated on the contemplation that, with respect to the deemed sale under section 338 of the Internal Revenue Code of 1954, paragraph (2) of section 1362(e) of such Code would apply, then the amendment made by paragraph (1) of subsection (g) shall not apply to such qualified stock purchase.

(4) AMENDMENT MADE BY SUBSECTION (t).—If—

(A) on or before the date of the enactment of this Act 50 percent or more of the stock of an S corporation has been sold or exchanged in 1 or more transactions, and

(B) the person (or persons) acquiring such stock establish by clear and convincing evidence that such acquisitions were negotiated on the contemplation that paragraph (2) of section 1262(e) of the Internal Revenue Code of 1954 would apply to the S termination year in which such sales or exchanges occur,

then the amendment made by subsection (t) shall not apply to such S termination year.

SEC. 622. MISCELLANEOUS PROVISIONS.

(a) AMENDMENTS RELATED TO TECHNICAL CORRECTIONS ACT OF 1982.—

(1) Paragraph (12) of section 57(a) (relating to accelerated cost recovery deduction) is amended—

(A) by striking out "(or, in the case of property described in section 167(k), under section 167)" in subparagraph (A), and

(B) by inserting "(or, in the case of property described in section 167(k), under section 167)" after "section 168(a)" in subparagraph (B).

(2) Subparagraph (A) of section 1256(g)(1) (defining foreign currency contract) is amended by inserting after "regulated futures contracts" the following: "(or the settlement of which depends on the value of such a currency)".

(3) Subclause (I) of section 306(a)(8)(A)(ii) of the Technical Corrections Act of 1982 is amended by striking out "the date of the enactment of the Tax Equity and Fiscal Responsibility Act of 1982" and inserting in lieu thereof "September 1, 1982".

(4)(A) Subparagraph (D) of section 105(c)(5) of the Technical Corrections Act of 1982 is amended by adding at the end thereof the following new clause:

"(iv) ELECTION BY TAXPAYER WITH RESPECT TO CONTRACTS ENTERED INTO AFTER JANUARY 12, 1983.—In lieu of the elections under clauses (ii) and (iii), a taxpayer may elect to have the amendments made by subparagraphs (B) and (C) apply only with respect to contracts entered into after January 12, 1983."

(B) Clause (i) of section 105(c)(5)(D) of such Act is amended by striking out "clauses (ii) and (iii)" and inserting in lieu thereof "clauses (ii), (iii), and (iv)".

(5)(A) Subparagraph (A) of section 172(b)(2) (relating to amount of carrybacks and carryovers) is amended by striking out "and (6)" and inserting in lieu thereof "and (5)".

(B) Subsection (d) of section 172 (relating to modifications) is amended by redesignating paragraphs (7) and (8) as paragraphs (6) and (7), respectively.

(6) Subsection (b) of section 5684 is amended by striking out "subsections (a) and (b)" and inserting in lieu thereof "subsection (a)".

(7) Any amendment made by this subsection shall take effect as if included in the provisions of the Technical Corrections Act of 1982 to which such amendment relates.

(b) COORDINATION OF CERTAIN AMENDMENTS MADE BY HIGHWAY REVENUE ACT OF 1982 AND PUBLIC LAW 97-473.—For purposes of applying the amendments made by section 547 of the Highway Revenue Act of 1982 and the amendment made by section 202(b)(2) of Public Law 97-473, Public Law 97-473 shall be deemed to have been enacted immediately before the Highway Revenue Act of 1982.

(c) NO DESIGNATION OF PRINCIPAL CAMPAIGN COMMITTEE REQUIRED WHERE ONLY ONE POLITICAL COMMITTEE.—Effective for taxable years beginning after December 31, 1981, subparagraph (B) of section 527(h)(2) (relating to special rule for principal campaign committees) is amended by adding at the end thereof the following new sentence: "Nothing in this subsection shall be construed to require any designation where there is only one political committee with respect to a candidate."

Subtitle C—Amendments Relating to Highway Revenue Act of 1982

SEC. 631. VALUE OF USED COMPONENTS FURNISHED BY FIRST USER NOT TAKEN INTO ACCOUNT IN DETERMINING PRICE.

Subparagraph (B) of section 4052(b)(1) (relating to determination of price) is amended by striking out "and" at the end of clause (ii) and by inserting after clause (iii) the following new clause:

"(iv) the value of any component of such article if—

"(I) such component is furnished by the first user of such article, and

"(II) such component has been used before such furnishing, and".

SEC. 632. CLARIFICATION OF APPLICATION OF GASOLINE EXCISE TAX TO GASOHOL, ETC.

(a) Gasoline Excise Tax To Apply to Gallon of Gasohol.—

(1) In general.—Paragraph (1) of section 4081(c) (relating to gasoline mixed with alcohol) is amended to read as follows:

"(1) In general.—Under regulations prescribed by the Secretary, subsection (a) shall be applied—

"(A) by substituting '4 cents' for '9 cents' in the case of the sale of any gasohol (the gasoline in which was not taxed under subparagraph (B)), and

"(B) by substituting '$4\frac{4}{9}$ cents' for '9 cents' in the case of the sale of any gasoline for use in producing gasohol.

For purposes of this paragraph, the term 'gasohol' means any mixture of gasoline if at least 10 percent of such mixture is alcohol."

(2) Later separation of gasoline.—Paragraph (2) of section 4081(c) is amended—

(A) by striking out "at the rate of 4 cents a gallon" and inserting in lieu thereof "at a rate equivalent to 4 cents a gallon", and

(B) by striking out "5 cents a gallon" and inserting in lieu thereof "$4\frac{5}{9}$ cents a gallon".

(3) CREDIT OR REFUND.—Paragraph (1) of section 6427(f) (relating to gasoline used to produce certain alcohol fuels) is amended by striking out "5 cents" and inserting in lieu thereof "4⅘ cents".

(b) LOWER FLOOR STOCKS TAX ON GASOHOL.—Subsection (a) of section 521 of the Highway Revenue Act of 1982 is amended by inserting "(4 cents a gallon in the case of a gallon of gasohol, as defined in section 4081(c))" after "5 cents a gallon".

SEC. 633. CERTAIN CHAIN OPERATORS OF RETAIL GASOLINE STATIONS TREATED AS PRODUCERS.

(a) IN GENERAL.—Subsection (d) of section 4082 (defining wholesale distributor) is amended to read as follows:

"(d) WHOLESALE DISTRIBUTOR.—As used in subsection (a), the term 'wholesale distributor' includes—

"(1) any person who—

"(A) sells gasoline to producers, retailers, or to users who purchase in bulk quantities and deliver into bulk storage tanks, or

"(B) purchases gasoline from a producer and distributes such gasoline to 10 or more retail gasoline stations under common management with such person,

"(2) but only if such person elects to register with respect to the tax imposed by section 4081.

Such term does not include any person who (excluding the term 'wholesale distributor' from subsection (a)) is a producer or importer."

(b) Effective Date.—The amendment made by subsection (a) shall take effect on the first day of the first calendar quarter beginning after the date of the enactment of this Act.

SEC. 634. OTHER TECHNICAL AMENDMENTS.

(a) Floor Stocks Refunds for Tires Taxed at Lower Rate After January 1, 1984.—

(1) In general.—Paragraph (1) of section 523(b) of the Highway Revenue Act of 1982 (relating to floor stocks refunds for tires) is amended by inserting "(or will be subject to a lower rate of tax under such section)" after "and which will not be subject to tax under such section".

(2) Amount of refund limited to reduction in tax.—Paragraph (2) of section 523(b) of such Act is amended by adding at the end thereof the following: "In the case of any tire which is a tax-repealed article solely by reason of the parenthetical matter in paragraph (1), the amount of the credit or refund under subsection (a) shall not exceed the excess of the tax imposed with respect to such tire by section 4071(a) as in effect on December 31, 1983, over the tax which

would have been imposed with respect to such tire by section 4071(a) on January 1, 1984."

(b) OVERPAYMENTS OF TAX ON TRUCKS, ETC., AND TIRES.—

(1) TRUCKS, ETC.—

(A) IN GENERAL.—Subsection (b) of section 6416 (relating to special cases in which tax payments considered overpayments) is amended by inserting after paragraph (5) the following new paragraph:

"(6) TRUCK CHASSIS, BODIES, AND SEMITRAILERS USED FOR FURTHER MANUFACTURE.—If—

"(A) the tax imposed by section 4051 has been paid with respect to the sale of any article, and

"(B) before any other use, such article is by any person used as a component part of another article taxable under section 4051 manufactured or produced by him,

such tax shall be deemed to be an overpayment by such person. For purposes of the preceding sentence, an article shall be treated as having been used as a component part of another article if, had it not been broken or rendered useless in the manufacture or production of such other article, it would have been so used."

(B) TECHNICAL AMENDMENT.—Subparagraph (B) of section 6416(a)(2) is amended by striking out "or (5)" and inserting in lieu thereof "(5), or (6)".

(2) TIRES.—

(A) IN GENERAL.—Paragraph (4) of section 6416(b) (relating to tires) is amended to read as follows:

"(4) TIRES.—If—

"(A) the tax imposed by section 4071 has been paid with respect to the sale of any tire by the manufacturer, producer, or importer thereof, and

"(B) such tire is sold by any person on or in connection with, or with the sale of, any other article, such tax shall be deemed to be an overpayment by such person if such other article is—

"(i) an automobile bus chassis or an automobile bus body, or

"(ii) by such person exported, sold to a State or local government for the exclusive use of a State or local government, sold to a nonprofit educational organization for its exclusive use, or used or sold for use as supplies for vessels or aircraft."

(B) TECHNICAL AMENDMENTS.—

(i) Paragraph (2) of section 6416(b) is amended by striking out subparagraph (E).

(ii) Paragraph (3) of section 6416(b) (relating to tax-paid articles used for further manufacture, etc.) is amended by striking out subparagraph (C).

(iii) Subparagraph (C) of section 6416(a)(1) is amended by striking out ", (b)(3) (C) or (D), or (b)(4)".

(iv) Subparagraph (B) of section 6416(a)(2), as amended by paragraph (1)(B), is amended by inserting "(4)," before "(5)".

(v) Subparagraph (3) of section 6416(a) is amended to read as follows:

"(3) SPECIAL RULE.—For purposes of this subsection, in any case in which the Secretary determines that an article is not taxable, the term 'ultimate purchaser' (when used in paragraph (1)(B) of this subsection) includes a wholesaler, jobber, distributor, or retailer who, on the 15th day after the date of such determination, holds such article for sale; but only if claim for credit or refund by reason of this paragraph is filed on or before the date for filing the return with respect to the taxes imposed under chapter 32 for the first period which begins more than 60 days after the date on such determination."

(c) ALLOWANCE OF TAX-FREE SALES OF GASOLINE FOR USE IN NONCOMMERCIAL AVIATION.—

(1) IN GENERAL.—Section 4082 (relating to definitions with respect to the tax on gasoline) is amended by adding at the end thereof the following new subsection:

"(e) CERTAIN SELLERS OF GASOLINE FOR USE IN NONCOMMERCIAL AVIATION TREATED AS PRODUCERS.—For purposes of this subpart, the term 'producer' includes any person who regularly sells gasoline to owners, lessees, or operators of aircraft for use as fuel in such aircraft in noncommercial aviation (as defined in section 4041(c)(4))."

(2) REFUNDS.—Section 6427 (relating to fuels not used for taxable purposes) is amended by redesignating subsections (j), (k), and (l) as subsections (k), (l), and (m), respectively, and by inserting after subsection (i) the following new subsection:

"(j) SPECIAL RULES WITH RESPECT TO NONCOMMERCIAL AVIATION.—For purposes of subsection (a), in the case of gasoline—

"(1) on which tax was imposed under section 4041(c)(2),

"(2) on which tax was not imposed under section 4081, and

"(3) which was not used as an off-highway business use (within the meaning of section 6421(d)(2)),

the amount of the payment under subsection (a) shall be an amount equal to the amount of gasoline used as described in subsection (a) or resold multiplied by the rate equal to the excess of the rate of tax imposed by section 4041(c)(2) over the rate of tax imposed by section 4081."

(3) EFFECTIVE DATE.—The amendments made by this subsection shall take effect on the first day of the first calendar quarter beginning after the date of the enactment of this Act.

(d) FLOOR STOCKS REFUNDS FOR TREAD RUBBER.—Paragraph (1) of section 523(b) of the Highway Revenue Act of 1982 (relating to floor stocks refunds for tires) is amended by adding at the end thereof the following new sentence: "Any tread rubber which was subject to tax under section 4071(a)(4) as in effect on December 31, 1983, and which on January 1, 1984, is part of a retread tire which is held by a dealer and has not been used and is intended for sale shall be treated as a tax-repealed article for purposes of subsection (a) of section 522."

(e) PENALTIES, ETC. TO APPLY TO FLOOR STOCKS TAXES.—Subsection (c) of section 521 of the Highway Revenue Act of 1982 is amended by adding at the end thereof the following: "All other provisions of law, including penalties, applicable with respect to the taxes imposed by section 4081 or 4071(a) (whichever is appropriate) shall apply to the floor stocks taxes imposed by this section."

(f) NO 1984 SHORT TAXABLE PERIOD FOR OWNER-OPERATORS.—Subsection (a) of section 4481 (relating to tax on use of certain vehicles), as in effect before the amendments made by the Highway Revenue Act of 1982, is amended by striking out the last sentence.

(g) CLARIFICATION OF SECONDARY LIABILITY OF INSTALLERS OF PARTS AND ACCESSORIES PURCHASED SEPARATELY.—The text of section 4051(b)(3) is amended to read as follows: "The owners of the trade or business installing the parts or accessories shall be secondarily liable for the tax imposed by paragraph (1)."

(h) NO INFERENCE FOR PAST PERIODS TO BE DRAWN FROM AMENDMENT RELATING TO CUSTOMARY USE OF TRAILERS.—The subsection heading of subsection (c) of section 513 of the Highway Revenue Act of 1982 is amended by striking out "Clarification of".

SEC. 635. REPEAL OF CERTAIN PROVISIONS MADE OBSOLETE BY HIGHWAY REVENUE ACT OF 1982.

(a) DELETION OF TERMINATED MANUFACTURERS EXCISE TAX ON MOTOR VEHICLES.—

(1) Part I of subchapter A of chapter 32 is amended by striking out sections 4061, 4062, and 4063.

(2) The part heading and the table of sections for such part I are amended to read as follows:

"PART I—GAS GUZZLERS

"Sec. 4064. Gas guzzlers tax."

(3) The table of parts for subchapter A of chapter 32 is amended by striking out the item relating to part I and inserting in lieu thereof the following:

"Part I. Gas guzzlers."

(b) CROSS-REFERENCES TO TERMINATED MANUFACTURERS EXCISE TAX ON MOTOR VEHICLES STATED AS PART OF RETAIL TAX.—

(1) EXEMPTIONS.—Section 4053 (relating to exemptions from retail tax on heavy trucks, etc.) is amended to read as follows:

"SEC. 4053. EXEMPTIONS.

"No tax shall be imposed by section 4051 on any of the following articles:

"(1) CAMPER COACHES BODIES FOR SELF-PROPELLED MOBILE HOMES.—Any article designed—

"(A) to be mounted or placed on automobile trucks, automobile truck chassis, or automobile chassis, and

"(B) to be used primarily as living quarters or camping accommodations.

"(2) FEED, SEED, AND FERTILIZER EQUIPMENT.—Any body primarily designed—

"(A) to process or prepare seed, feed, or fertilizer for use on farms,

"(B) to haul feed, seed, or fertilizer to and on farms,

"(C) to spread feed, seed, or fertilizer on farms,

"(D) to load or unload feed, seed, or fertilizer on farms, or

"(E) for any combination of the foregoing.

"(3) HOUSE TRAILERS.—Any house trailer.

"(4) AMBULANCES, HEARSES, ETC.—Any ambulance, hearse, or combination ambulance-hearse.

"(5) CONCRETE MIXERS.—Any article designed—

"(A) to be placed or mounted on an automobile truck chassis or truck trailer or semitrailer chassis, and

"(B) to be used to process or prepare concrete.

"(6) TRASH CONTAINERS, ETC.—Any box, container, receptacle, bin or other similar article—

"(A) which is designed to be used as a trash container and is not designed for the transportation of freight other than trash, and

"(B) which is not designed to be permanently mounted on or permanently affixed to an automobile truck chassis or body.

"(7) RAIL TRAILERS AND RAIL VANS.—Any chassis or body of a trailer or semitrailer which is designed for use both as a highway vehicle and a railroad car. For purposes of the preceding sentence, piggyback trailer or semitrailer shall not be treated as designed for use as a railroad car."

(2) CERTAIN COMBINATIONS NOT TREATED AS MANUFACTURE.—Subsection (c) of section 4052 (relating to definitions and special rules) is amended to read as follows:

"(c) CERTAIN COMBINATIONS NOT TREATED AS MANUFACTURE.—

"(1) IN GENERAL.—For purposes of this subchapter (other than subsection (a)(3)(B)), a person shall not be treated as engaged in the manufacture of any article by reason of merely combining such article with any item listed in paragraph (2).

"(2) ITEMS.—The items listed in this paragraph are any coupling device (including any fifth wheel), wrecker crane, loading and unloading equipment (including any crane, hoist, winch, or power liftgate), aerial ladder or tower, snow and ice control equipment, earthmoving, excavation and construction equipment, spreader, sleeper cab, cab shield, or wood or metal floor."

(c) OTHER TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Clause (i) of section 48(l)(16)(B) (defining qualified intercity bus) is amended to read as follows:

"(i) the chassis of which is an automobile bus chassis and the body of which is an automobile bus body,".

(2)(A) The first sentence of section 4071(b) is amended by striking out "or inner tube" and by striking out "or tube" each place it appears.

(B) The first sentence of section 4071(c) is amended by striking out "on total weight," and all that follows and inserting in lieu thereof "on total weight exclusive of metal rims or rim bases."

(C) Subsection (e) of section 4071 is amended—

(i) by striking out "or inner tubes (other than bicycle tires and inner tubes)",

(ii) by striking out "and inner tubes" in paragraphs (1) and (2), and

(iii) by striking out the last sentence and inserting in lieu thereof the following: "This subsection shall not apply with respect to the sale of an automobile bus chassis or an automobile bus body."

(D) Subsection (f) of section 4071 (relating to imported recapped or retreaded United States tires) is hereby repealed.

(3) Section 4072 (relating to definitions) is amended by striking out subsection (b) and by redesignating subsection (c) as subsection (b).

(4) Section 4073 (relating to exemptions) is amended to read as follows:

"SEC. 4073. EXEMPTION FOR TIRES WITH INTERNAL WIRE FASTENING.

"The tax imposed by section 4071 shall not apply to tires of extruded tiring with an internal wire fastening agent."

(5)(A) The heading for part II of subchapter A of chapter 32 is amended by striking out "**AND TUBES**".

(B) The table of parts for subchapter A of chapter 32 is amended by striking out "and tubes" in the item relating to part II.

(C) The item relating to section 4073 in the table of sections for part II of subchapter A of chapter 32 is amended to read as follows:

"Sec. 4073. Exemption for tires with internal wire fastening."

(6)(A) Paragraph (1) of section 4216(b) (defining constructive sale price) is amended—

(i) by striking out "(other than an article the sale of which is taxable under section 4061(a))" in the second sentence, and

(ii) by striking out the third sentence.

(B) Paragraph (2) of section 4216(b) is amended by striking out subparagraph (C), by adding "and" at the end of subparagraph (B), and by redesignating subparagraph (D) as subparagraph (C).

(C) Subsection (b) of section 4216 is amended by striking out paragraph (5).

(D) Paragraph (3) of section 4216(b) is amended by striking out "paragraphs (4) and (5)" and inserting in lieu thereof "paragraph (4)".

(E) Paragraph (6) of section 4216(b) is redesignated as paragraph (5) and is amended by striking out "(1), (3), and (5)" and inserting in lieu thereof "(1) and (3)".

(F) Subsection (f) of section 4216 (relating to certain trucks incorporating used components) is hereby repealed.

(7)(A) Subsection (b) of section 4218 (relating to use by manufacturer or importer considered as sale) is amended—

(i) by striking out "or inner tube", and

(ii) by striking out "Except as provided in subsection (d), if" and inserting in lieu thereof "If".

(B) The heading for subsection (b) of section 4218 is amended by striking out "and Tubes".

(C) Section 4218 is amended by striking out subsections (c) and (d) and by redesignating subsection (e) as subsection (c).

(D) Subsection (a) of section 4218 is amended by striking out "(other than an article specified in subsection (b), (c), or (d))" and inserting in lieu thereof "(other than a tire taxable under section 4071)".

(8)(A) Subsection (a) of section 4221 (relating to tax-free sales) is amended by inserting "(or under section 4051 on the first retail sale)" after "manufacturer".

(B) Subsection (c) of section 4221 is amended by striking out "section 4063(a) (6) or (7), 4063(b), 4063(e)," and inserting in lieu thereof "section 4053(a)(6)".

(C) Paragraph (1) of section 4221(d) (defining manufacturer) is amended by inserting before the period ", and, in the case of the tax imposed by section 4051, includes the retailer with respect to the first retail sale".

(D) Paragraph (6) of section 4221(d) (relating to use in further manufacture) is amended—

(i) by striking out subparagraph (B) and the last sentence,

(ii) by striking out "(other than an article referred to in subparagraph (B))" in subparagraph (A),

(iii) by redesignating subparagraph (C) as subparagraph (B), and

(iv) by adding "or" at the end of subparagraph (A).

(E) Paragraph (2) of section 4221(e) is amended—

(i) by striking out "or inner tube" each place it appears; and

(ii) by striking out "or tube" each place it appears.

(F) The heading for paragraph (2) of section 4221(e) is amended by striking out "AND TUBES".

(G) Subsection (e) of section 4221 is amended by striking out paragraphs (4), (5), and (6) and inserting in lieu thereof the following:

"(3) TIRES USED ON INTERCITY, LOCAL, AND SCHOOL BUSES.—Under regulations prescribed by the Secretary, the tax imposed by section 4071 shall not apply in the case of tires sold for use by the purchaser on or in connection with a qualified bus."

(9) Subsection (d) of section 4222 is amended by striking out "4063(a)(7), 4063(b), 4063(e)," and inserting in lieu thereof "4053(a)(6),".

(10) Paragraph (1) of section 4223(b) is amended by striking out "section 4218(e)" and inserting in lieu thereof "4218(c)".

(11) Paragraph (2) of section 4227 is amended by striking out "and tubes".

(12)(A) So much of paragraph (1) of section 6412(a) (relating to floor stock refunds) as precedes "there shall be credited or refunded" is amended to read as follows:

"(1) TIRES AND GASOLINE.—Where before October 1, 1988, any article subject to the tax imposed by section 4071 or 4081 has been sold by the manufacturer, producer, or importer and on such date is held by a dealer and has not been used and is intended for sale,".

(B) Paragraph (1) of section 6412(a) is amended by striking out the last sentence.

(C) Subparagraph (A) of section 6412(a)(2) is amended to read as follows:

"(A) The term 'dealer' includes a wholesaler, jobber, distributor, or retailer."

(D) Subsection (c) of section 6412 is amended by striking out "4061, 4071," and inserting in lieu thereof "4071".

(13)(A) Subparagraph (C) of section 6416(b)(1) (relating to adjustment of tire price) is amended by striking out "section 4071(a) (1) or (2) or section 4071(b)" and inserting in lieu thereof "subsection (a) or (b) of section 4071".

(B) Paragraph (2) of section 6416(b) is amended by striking out subparagraph (F) and all that follows to the end thereof and inserting in lieu thereof the following:

"(E) in the case of any tire taxable under section 4071(a), sold to any person for use as described in section 4221(e)(3); or

"(F) in the case of gasoline, used or sold for use in the production of special fuels referred to in section 4041.

Subparagraphs (C) and (D) shall not apply in the case of any tax paid under section 4064."

(C) Paragraph (3) of section 6416(b) is amended by striking out all subparagraphs and the last sentence thereof and inserting in lieu thereof the following:

"(A) in the case of any article other than gasoline taxable under section 4081, such article is used by the subsequent manufacturer or producer as material in the manufacture or production of, or as a component part of—

"(i) another article taxable under chapter 32, or

"(ii) an automobile bus chassis or an automobile bus body,

manufactured or produced by him; or

"(B) in the case of gasoline taxable under section 4081, such gasoline is used by the subsequent manufacturer or producer, for nonfuel purposes, as a material in the manufacture or production of any other article manufactured or produced by him."

(D) Subparagraph (B) of section 6416(a)(2) is amended by striking out "or (B)".

(E) Section 6416 is amended by striking out subsections (c) and (g) and by redesignating subsections (e), (f), (h), and (i) as subsections (c), (d), (e), and (f), respectively.

(F) Subparagraph (A) of section 6416(b)(2) is amended by striking out "(except in any case to which subsection (g) applies)".

(14) Section 6511 is amended by striking out subsection (i) and by redesignating subsection (j) as subsection (i).

(15) Paragraph (3) of section 9502(b) is amended by striking out "under paragraphs (2) and (3) of section 4071(a), with respect to tires and tubes of types used on aircraft" and inserting in lieu thereof "under section 4071 with respect to tires of the types used on aircraft".

(16) Sections 1366(f)(1) and 6401(b) are each amended by striking out ", special fuels, and lubricating oil" and inserting in lieu thereof "and special fuels".

SEC. 636. EFFECTIVE DATE.

Except as otherwise provided in this subtitle, any amendment made by this subtitle shall take effect as if included in the provisions of the Highway Revenue Act of 1982 to which such amendment relates.

Subtitle D—Amendments to Other Laws

PART I—CHANGES IN OASDI, PUBLIC ASSISTANCE, AND RELATED PROVISIONS OF THE SOCIAL SECURITY ACT

SEC. 641. CHANGES IN TITLE II OF THE SOCIAL SECURITY ACT NECESSITATED BY THE 1983 AMENDMENTS.

(a) Section 201(l)(3)(B)(i) of the Social Security Act (as added by section 142(a)(3)(B) of the Social Security Amendments of 1983 (in this part referred to as the "1983 Amendments")) is amended by inserting "Insurance" after "Survivors".

(b)(1) Section 202(c)(1) of such Act is amended (in the matter appearing between subparagraphs (D) and (E) of such section, as amended by section 301(a)(2)(C) of the 1983 Amendments)—

(A) by striking out all that follows "has attained" and precedes ", the first month" in clause (i) and inserting in lieu thereof "retirement age (as defined in section 216(l))";

(B) by striking out all that follows "has not attained" and precedes ", or" in clause (ii)(I) and inserting in lieu thereof "retirement age (as defined in section 216(l))"; and

(C) by striking out "to which" in the matter following clause (ii) and inserting in lieu thereof "in which".

(2) Section 202(c)(5)(A) of such Act (as added by section 301(a)(5) of the 1983 Amendments) is amended by striking out "classes (i) and (ii)" and inserting in lieu thereof "clauses (i) and (ii)".

(c)(1) Section 202(e)(2)(A) of such Act (as amended by section 133(a)(1)(B) of the 1983 Amendments) is amended by striking out all that follows "subsection (q)," and precedes "subparagraph (D) of this paragraph" and inserting in lieu thereof "paragraph (7) of this subsection, and".

(2) Section 202(e)(2)(C) of such Act (as designated and amended by section 133(a)(1)(B) of the 1983 Amendments) is amended—

(A) by striking out the period immediately after "deceased individual"; and

(B) by inserting a closing parenthesis after "paragraph (3) of such subsection (w)".

(3) Paragraph (7) of section 202(e) of such Act (as redesignated by section 131(a)(3)(A) of the 1983 Amendments) is amended by striking out "paragraph (2)(B)," and inserting in lieu thereof "paragraph (2)(D),".

(d)(1) Section 202(f)(1)(C)(ii) of such Act (as added by section 306(g) of the 1983 Amendments) is amended by striking out all that follows "attained" and precedes ", and" and inserting in lieu thereof "retirement age (as defined in section 216(l))".

(2) Section 202(f)(2)(A) of such Act is amended by striking out "paragraph (3)(B)," and inserting in lieu thereof "paragraph (3)(D),".

(3) Section 202(f)(3)(C) of such Act (as designated and amended by section 133(b)(1)(B) of the 1983 Amendments) is amended by striking out the period immediately after "deceased individual".

(e) Section 202(q)(9)(B)(i) of such Act (as amended by section 201(b)(1) of the 1983 Amendments) is amended by striking out "section 216(a)" and inserting in lieu thereof "section 216(l)".

(f) Section 202(x) of such Act (as added by section 339(a) of the 1983 Amendments) is amended by adding at the beginning thereof the following heading:

"Limitation on Payments to Prisoners".

(g)(1) Section 203(d) of such Act (as amended by sections 132(b)(2) and 309(h) of the 1983 Amendments) is amended—

(A) by striking out "on seven or more different calendar days of which he engaged" in paragraph

(1)(A) and inserting in lieu thereof "for more than forty-five hours of which such individual engaged"; and

(B) by striking out "on seven or more different calendar days" in paragraph (2) and inserting in lieu thereof "for more than forty-five hours".

(2) The amendments made by paragraph (1) shall apply only with respect to months beginning with the second month after the month in which this Act is enacted.

(h) Section 205(r) of such Act (as added by section 336 of the 1983 Amendments) is amended—

(1) by striking out "(r)(3)(A) and (r)(3)(B)" in paragraph (4) and inserting in lieu thereof "subparagraphs (A) and (B) of paragraph (3)";

(2) by striking out "the Act" in paragraph (7) and inserting in lieu thereof "this Act"; and

(3) by striking out the heading and inserting in lieu thereof the following:

"Use of Death Certificates to Correct Program Information".

(i)(1) Section 209(e) of such Act (as amended by section 324(c)(2) of the 1983 Amendments) is amended by striking out the semicolon after "Act of 1974".

(2) Section 209 of such Act is further amended by striking out "section 414(h)(2) of such Code" in the material added by section 324(c)(1) of the 1983 Amendments and in-

serting in lieu thereof "section 414(h)(2) of such Code where the pickup referred to in such section is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise)".

(j)(1) Section 210(a) of such Act (as amended by sections 321(b) and 322(a)(1)(B) of the 1983 Amendments), in the matter preceding paragraph (1), is amended by striking out the matter which follows "such affiliate" and precedes "or (C)" and the matter which follows "section 233" and precedes "except", and by inserting in lieu thereof a comma and a semicolon, respectively.

(2) Section 210(a)(5)(B) of such Act (as amended by section 101(a)(1) of the 1983 Amendments) is amended to read as follows:

"(B) is performed by an individual who—

"(i) has been continuously performing service described in subparagraph (A) since December 31, 1983, and for purposes of this clause—

"(I) if an individual performing service described in subparagraph (A) returns to the performance of such service after being separated therefrom for a period of less than 366 consecutive days, regardless of whether the period began before, on, or after December

31, 1983, then such service shall be considered continuous.

"(II) if an individual performing service described in subparagraph (A) returns to the performance of such service after being detailed or transferred to an international organization as described under section 3343 of subchapter III of chapter 33 of title 5, United States Code, or under section 3581 of chapter 35 of such title, then the service performed for that organization shall be considered service described in subparagraph (A),

"(III) if an individual performing service described in subparagraph (A) is reemployed or reinstated after being separated from such service for the purpose of accepting employment with the American Institute of Taiwan as provided under section 3310 of chapter 48 of title 22, United States Code, then the service performed for that Institute shall be considered service described in subparagraph (A), and

"(IV) if an individual performing service described in subparagraph (A) returns to the performance of such service after performing service as a member of a uniformed service (including, for purposes of this clause, service in the National Guard and temporary service in the Coast Guard Reserve) and after exercising restoration or reemployment rights as provided under chapter 43 of title 38, United States Code, then the service so performed as a member of a uniformed service shall be considered service described in subparagraph (A); or

"(ii) is receiving an annuity from the Civil Service Retirement and Disability Fund, or benefits (for service as an employee) under another retirement system established by a law of the United States for employees of the Federal Government (other than for members of the uniformed services);".

(3) Section 210(a)(5)(v) of such Act (as so amended) is amended to read as follows:

"(v) any other service in the legislative branch of the Federal Government if such service—

"(I) is performed by an individual who was not subject to subchapter III of chapter

83 of title 5, United States Code, or to another retirement system established by a law of the United States for employees of the Federal Government (other than for members of the uniformed services), on December 31, 1983, or

"(II) is performed by an individual who was subject to subchapter III of chapter 83 of such title 5, or to another retirement system established by a law of the United States for employees of the Federal Government (other than for members of the uniformed services), on December 31, 1983, but who—

"(a) commenced the performance of such service in the legislative branch after that date, or

"(b) was separated from service in the legislative branch after that date and has returned to the performance of such service,

unless such individual becomes subject to such subchapter III within 45 days after the effective date of such commencement or return (or, if later, within 45 days after the date of the enactment of this subclause), or remains subject to such other retirement system, and unless (in the case of a separation and return described in subdivision (b)) the period of the separation was less than 366 consecutive days;

and for purposes of this clause (v) an individual is subject to such subchapter III or to any such other retirement system at any time only if (1) such individual's pay is subject to deductions, contributions, or similar payments (concurrent with the service being performed at that time) under section 8334(a) of such title 5 or the corresponding provision of the law establishing such other system, or (in a case to which section 8332(k)(1) of such title applies) such individual is making payments of amounts equivalent to such deductions, contributions, or similar payments while on leave without pay, or (2) such individual is receiving an annuity from the Civil Service Retirement and Disability Fund, or is receiving benefits (for service as an employee) under another retirement system established by a law of the United States for employees of the Federal Government (other than for members of the uniformed services);".

(4) The amendments made by paragraphs (2) and (3) shall be effective with respect to service performed after December 31, 1984.

(k)(1) Section 215(a)(7)(B)(ii)(I) of such Act (as added by section 113(a) of the 1983 Amendments) is amended by striking out "who initially become eligible for old-age or disability insurance benefits" and inserting in lieu thereof "who become eligible (as defined in paragraph (3)(B)) for old-age insurance benefits (or became eligible as so defined for disability insurance benefits before attaining age 62)".

(2) Section 215(a)(7)(C)(ii) of such Act (as so added) is amended by striking out "survivors" and inserting in lieu thereof "survivor's".

(3) Section 215(f)(9)(B)(i) of such Act (as added by section 113(c) of the 1983 Amendments) is amended by striking out "as though such primary insurance amount had initially been computed without regard to subsection (a)(7) or (d)(5)" and inserting in lieu thereof "as though the recomputed primary insurance amount were being computed under subsection (a)(7) or (d)(5)".

(4) Section 215(i)(5)(A) of such Act (as added by section 112(c) of the 1983 Amendments) is amended by adding at the end thereof the following new sentence: "Any amount so increased that is not a multiple of $0.10 shall be decreased to the next lower multiple of $0.10.".

(5) Section 215(i)(5)(B) of such Act (as so added) is amended—

(A) by striking out clause (iii) and inserting in lieu thereof the following:

"(iii) multiplying such quotient by 100 so as to yield such applicable additional percentage (which shall be rounded to the nearest one-tenth of 1 percent),";

(B) by striking out "ending with such subsequent calendar year" in clauses (iv) and (v) and inserting in lieu thereof "ending with the year before such subsequent calendar year"; and

(C) by striking out "initially became eligible for an old-age or disability insurance benefit" in clause (v) and inserting in lieu thereof "became eligible (as defined in subsection (a)(3)(B)) for the old-age or disability insurance benefit that is being increased under this subsection".

(l)(1) Section 216(f) of such Act is amended by adding at the end thereof the following new sentence: "For purposes of subparagraph (C) of section 202(c)(1), a divorced husband shall be deemed not to be married throughout the month in which he becomes divorced.".

(2) Section 216(h)(3)(A)(i) of such Act (as amended by section 201(c)(1)(D) of the 1983 Amendments (after the application of section 642(b)(1) of this Act)) is amended by strik-

ing out "(as defined in section 216(l))" and inserting in lieu thereof "(as defined in subsection (l))".

(3) Section 216(i)(2) of such Act (as amended by section 201(c)(1)(D) of the 1983 Amendments (after the application of section 642(b)(1) of this Act)) is amended by striking out "(as defined in section 216(l))" in subparagraphs (B) and (D) and inserting in lieu thereof "(as defined in subsection (l))".

(m) Subparagraph (B) of section 223(c)(1) of such Act is amended by moving clause (iii) (as added by section 332(b)(2) of the 1983 Amendments) two ems to the left, and by moving the preceding provisions of such subparagraph two ems to the right, so that the left margin of such subparagraph and its clauses is indented four ems and is aligned with the margin of subparagraph (A) of such section.

(n) Section 229(b) of such Act (as amended by section 151(b)(1) of the 1983 Amendments) is amended by adding at the end thereof the following new sentence: "Additional adjustments may be made in the amounts so authorized to be appropriated to the extent that the amounts transferred in accordance with clauses (i) and (ii) of section 151(b)(3)(B) of the Social Security Amendments of 1983 with respect to wages deemed to have been paid in 1983 were in excess of or were less than the amount which the Secretary, on the basis of appropriate data, determines should have been so transferred.".

SEC. 642. CHANGES IN TEXT OF THE 1983 AMENDMENTS.

(a) Section 101(d) of the Social Security Amendments of 1983 (Public Law 98–21) is amended by striking out "remuneration paid" and inserting in lieu thereof "service performed".

(b) Section 112(f) of such Amendments is amended by inserting "of such Act" after "section 201(a)".

(c) Section 201(c) of such Amendments is amended—

(1) by inserting "the" immediately before "age of 65" in paragraph (1); and

(2) by inserting "the" immediately before "age of sixty-five" in paragraph (3).

(d) Section 301(a)(5) of such Amendments is amended by striking out "Section 202(c)" and inserting in lieu thereof "Effective with respect to monthly insurance benefits for months after December 1984 (but only on the basis of applications filed on or after January 1, 1985), section 202(c)".

(e) Section 305(d)(2) of such Amendments is amended by inserting "each place it appears" immediately before "in subsection (c)(4)(C)".

(f)(1) Section 422A(c)(9) of the Internal Revenue Code of 1954 (relating to special rule when disabled) is amended by striking out "section 105(d)(4)" and inserting in lieu thereof "section 37(e)(3)".

(2)(A) Section 324(d)(1) of the Social Security Amendments of 1983 is amended by adding at the end thereof the following new sentence: "For purposes of applying such amendments to remuneration paid after December 31, 1983, which would have been taken into account before January 1, 1984, if such amendments had applied to periods before January 1, 1984, such remuneration shall be taken into account when paid (or, at the election of the payor, at the time which would be appropriate if such amendments had applied).".

(B) Section 324(d)(2) of such Amendments is amended by adding at the end thereof the following new sentence: "For purposes of applying such amendments to remuneration paid after December 31, 1984, which would have been taken into account before January 1, 1985, if such amendments had applied to periods before January 1, 1985, such remuneration shall be taken into account when paid (or, at the election of the payor, at the time which would be appropriate if such amendments had applied).".

(C) Section 324(d)(4) of such Amendments is amended by adding at the end thereof the following new sentence: "For purposes of this paragraph, any plan or agreement to make payments described in paragraph (2), (3), or (13)(A)(iii) of section 3121(a) of such Code (as in effect on the day before the date of the enactment of this Act) shall be treated as a nonqualified deferred compensation plan.".

(g) Section 327(d) of such Amendments (relating to codification of Rowan decision with respect to meals and lodging) is amended to read as follows:

"(d)(1) The amendments made by subsection (a) shall apply to remuneration paid after December 31, 1983.

"(2) The amendments made by subsection (b) and subsection (c)(4) shall apply to remuneration (other than amounts excluded under section 119 of the Internal Revenue Code of 1954) paid after March 4, 1983, and to any such remuneration paid on or before such date which the employer treated as wages when paid.

"(3) The amendments made by paragraphs (1), (2), and (3) of subsection (c) shall apply to remuneration paid after December 31, 1984.".

(h)(1) The second sentence of section 338(b)(3) of such amendments is amended to read as follows: "Each member of the Panel shall be allowed travel and related expenses which shall be subject to the same regulations and limitations (insofar as they are applicable) as those which the Senate Committee on Rules and Administration prescribes for application to travel and related expenses for which payment is authorized to be made from the contingent fund of the Senate.".

(2) Section 338(b) of such amendments is further amended by adding at the end thereof the following new paragraph:

"(6) The provisions of section 8344 of title 5, United States Code, shall not apply to service by an individual as a member of the Panel.".

(3) The amendments made by this subsection shall take effect on January 1, 1984.

(i) Section 339(b) of such amendments is amended to read as follows:

"(b) Section 223 of such Act is amended by adding at the end thereof the following new subsection:

" '(h) For provisions relating to limitation on payments to prisoners, see section 202(x).'.".

(j) Section 111(e) of such Amendments is amended by inserting "Budget" before "Reconciliation".

SEC. 643. OTHER TECHNICAL CORRECTIONS IN THE SOCIAL SECURITY ACT AND RELATED PROVISIONS.

(a)(1)(A) The fourth sentence of section 201(d) of the Social Security Act is amended—

(i) by striking out "the Second Liberty Bond Act, as amended," and inserting in lieu thereof "chapter 31 of title 31, United States Code,"; and

(ii) by striking out "public-debt obligation" and inserting in lieu thereof "public-debt obligations".

(B) Section 201(g)(1)(B) of such Act is amended by striking out "clauses" in the first sentence and inserting in lieu thereof "clause".

(2)(A)(i) Section 202(d)(1) of such Act, in clause (ii) in the matter which follows subparagraph (C) and precedes subparagraph (D), is amended by striking out "paragraphs" and "paragraph" and inserting in lieu thereof "subparagraphs" and "subparagraph", respectively.

(ii) Section 202(d)(1)(G) of such Act is amended—

(I) by striking out the comma after "age of 18";

(II) by striking out "the age of 22," and inserting in lieu thereof "the age of 22—";

(III) by striking out ", or, subject to section 223(e), the termination month (and for purposes" and inserting in lieu thereof the following:

"(i) the termination month, subject to section 223(e) (and for purposes";

(IV) by striking out "after the 15 months" and all that follows down through "such earlier month." and inserting in lieu thereof the following:

"after the 15 months following such period of trial work in which he engages or is determined able to engage in substantial gainful activity),

or (if later) the earlier of—

"(ii) the first month during no part of which he is a full-time elementary or secondary school student, or "(iii) the month in which he attains the age of 19,

but only if he was not under a disability (as so defined) in such earlier month."; and

(V) by indenting all of clause (i) (as designated and amended by the preceding provisions of this subparagraph) four ems, so as to align its left margin with the margins of clauses (ii) and (iii) (as so designated).

(iii) The second sentence of section 202(d)(7)(A) of such Act is amended by striking out "the date of the enactment of this paragraph" and inserting in lieu thereof "the effective date of this sentence".

(B) Section 202(e)(1) of such Act is amended—

(i) by striking out the first comma after "age 60" in the matter following subparagraph (F)(ii); and

(ii) by striking out "he engages" in the last sentence and inserting in lieu thereof "she engages".

(C) Section 202(f)(1) of such Act is amended by striking out the first comma after "age 60" in the matter following subparagraph (F)(ii).

(D) Section 202(f)(3)(D)(i) of such Act is amended by striking out the semicolon after "applicable,".

(E) Section 2202(a)(1)(B) of Public Law 97-35 is amended by striking out "as".

(F)(i) Section 202(q)(3)(G) of the Social Security Act is amended by striking out "as if the period" and inserting in lieu thereof "if the period".

(ii) Section 202(q)(7)(E) of such Act is amended by striking out "he attained retirement age" and inserting in lieu thereof "she or he attained retirement age".

(G) Section 202(t)(4)(E) of such Act is amended—

(i) by inserting "of 1937 or 1974" after "Railroad Retirement Act" where it first appears; and

(ii) by inserting before the semicolon at the end thereof the following: "of 1937 or section 18(2) of the Railroad Retirement Act of 1974".

(H) Section 202(u)(1)(B) of such Act is amended by striking out ", 112, or 113".

(3)(A) Section 203(a)(8) of such Act is amended by adding a period at the end thereof.

(B) Section 203(d)(2) of such Act is amended by striking out "an individual who is entitled" and inserting in lieu thereof "an individual under the age of seventy who is entitled".

(C) Section 203(f)(5)(B)(ii) of such Act is amended by striking out "702(a)(9)" and inserting in lieu thereof "702(a)(8)".

(D) Section 203(f)(8) of such Act is amended by indenting subparagraphs (B) and (C) two additional ems (for a total indentation of four ems) so as to align their left margins with the margins of subparagraphs (A) and (D).

(4)(A) Section 205(c)(5)(D) of such Act is amended by inserting "of 1937 or 1974" after "Railroad Retirement Act" each place it appears.

(B) Section 205(c)(5)(I) of such Act is amended by inserting before the semicolon at the end thereof the following: "or section 7(b)(7) of the Railroad Retirement Act of 1974".

(C) Section 205(e) of such Act is amended by striking out "on order" and inserting in lieu thereof "an order".

(D) Section 205(h) of such Act is amended by striking out "section 24 of the Judicial Code of the United States" and inserting in lieu thereof "section 1331 or 1346 of title 28, United States Code,".

(E) Section 205(i) of such Act is amended by striking out all that follows "through" and precedes "and prior" and inserting in lieu thereof "the Fiscal Service of the Department of the Treasury,".

(F) Section 205(p)(1) of such Act is amended by striking out "section 1420(e) of the Internal Revenue Code" and inserting in lieu thereof "section 3122 of the Internal Revenue Code of 1954".

(5) Section 208 of such Act is amended by indenting paragraphs (f) through (h) two ems so as to align their left margins with the margins of paragraphs (a) through (e) (and

by appropriately further indenting subdivisions (1), (2), and (3) of paragraph (g)).

(6)(A) Section 209 of such Act is amended—

(i) by indenting paragraphs (5) through (9) of subsection (a) two ems so as to align their left margins with the margins of the preceding paragraphs of such subsection;

(ii) by striking out "(p) Remuneration" and inserting in lieu thereof "(p)(1) Remuneration";

(iii) by striking out the period at the end of paragraph (p)(1) as redesignated by clause (ii) of this subparagraph and inserting in lieu thereof a semicolon;

(iv) by striking out "(p) Any contribution" and inserting in lieu thereof "(2) Any contribution"; and

(v) by indenting subsections (e), (f), and (k) through (r) two ems so as to align their left margins with the margins of subsections (a) through (d) and subsections (g), (h), and (j) (appropriately further indenting paragraphs (1) and (2) of subsection (f) and paragraphs (1) and (2) of subsection (m)).

(B) The seventh paragraph from the end of section 209 of such Act (relating to remuneration for service performed as a member of a uniformed service) is amended by striking out "section 102(10) of the Servicemen's and Veterans' Survivor Benefits Act" and inserting in lieu thereof "chapter 3 and section 1009 of title 37, United States Code".

(7)(A) Section 210(a)(1) of such Act is amended by striking out "(A)" and all that follows down through "or (B)".

(B) Section 210(a)(7) of such Act is amended by indenting subparagraph (D) two additional ems (for a total indentation of four ems) so as to align its left margin with the margins of subparagraphs (A) through (C).

(C) Section 210(a)(9) of such Act is amended by striking out "section 1532 of the Internal Revenue Code" and inserting in lieu thereof "section 3231 of the Internal Revenue Code of 1954".

(D) Section 210(a)(19) of such Act is amended by striking out the comma after "; or".

(E) Section 210(l)(2) of such Act is amended—

(i) by striking out "section 102 of the Servicemen's and Veterans' Survivor Benefits Act" and inserting in lieu thereof "paragraph (21) of section 101 of title 38, United States Code"; and

(ii) by striking out "such section" and inserting in lieu thereof "paragraph (22) of such section".

(F) Section 210(l)(3) of such Act is amended by striking out "such section 102" and inserting in lieu thereof "paragraph (23) of such section 101".

(G) Section 210(m) of such Act is amended—

(i) by striking out "a reserve component of a uniformed service as defined in section 102(3) of the Servicemen's and Veterans' Survivor Benefits Act" in the first sentence and inserting in lieu thereof "a reserve component as defined in section 101(27) of title 38, United States Code";

(ii) by inserting ", the National Oceanic and Atmospheric Administration Corps," after "Coast and Geodetic Survey" in the first sentence;

(iii) by striking out "military or naval" each place it appears in paragraph (5) and inserting in lieu thereof "military, naval, or air"; and

(iv) by striking out "Universal Military Training and Service Act" in paragraph (5)(B) and inserting in lieu thereof "Military Selective Service Act".

(8)(A) Section 211(a) of such Act is amended by striking out "chapter 1 of the Internal Revenue Code", "such chapter", and "section 183 of such code" in the matter preceding paragraph (1) and inserting in lieu thereof "subtitle A of the Internal Revenue Code of 1954", "such subtitle", and "section 702(a)(8) of such Code", respectively.

(B) Section 211(a)(3) of such Act is amended—

(i) by striking out "chapter 1 of the Internal Revenue Code" and inserting in lieu thereof "subtitle A of the Internal Revenue Code of 1954"; and

(ii) by inserting "or" before "(C)".

(C) Section 211(a)(4) of such Act is amended by striking out "section 23(s) of such code" and inserting in lieu thereof "section 172 of the Internal Revenue Code of 1954".

(D) Section 211(a) of such Act is further amended by striking out "702(a)(9)" in clauses (iii) and (iv) (in the matter following paragraph (12)) and inserting in lieu thereof in each instance "702(a)(8)".

(E) Section 211(b)(1) of such Act is amended by indenting subparagraphs (D), (G), (H), and (I) an additional two ems (for a total indentation of four ems) so as to align their left margins with the margins of the other subparagraphs of such section.

(F) Section 211(c) of such Act is amended by striking out "section 23 of the Internal Revenue Code" and inserting in lieu thereof "section 162 of the Internal Revenue Code of 1954".

(G) Section 211(c)(3) of such Act is amended by striking out "section 1532 of the Internal Revenue Code" and inserting in lieu thereof "section 3231 of the Internal Revenue Code of 1954".

(H) Section 211(d) of such Act is amended by striking out "supplement F of chapter 1 of the Internal Revenue Code" and inserting in lieu thereof "subchapter K of chapter 1 of the Internal Revenue Code of 1954".

(I) Section 211(e) of such Act is amended by striking out "chapter 1 of the Internal Revenue Code", "chapter 1 of such code", and "such chapter 1" and inserting in lieu thereof "subtitle A of the Internal Revenue Code of 1954", "subtitle A of such Code", and "such subtitle A", respectively.

(9)(A) Section 213(a)(1) of such Act is amended by striking out "means" and inserting in lieu thereof "mean".

(B) Section 213(a)(2)(B)(ii) of such Act is amended by striking out "equal to $3,000" and inserting in lieu thereof "equal $3,000".

(10)(A) Section 215(a)(1) of such Act is amended—

(i) by striking out "of such benefits" in subparagraph (B)(i) and inserting in lieu thereof "for such benefits";

(ii) by striking out "amounts" in subparagraph (B)(iii) and inserting in lieu thereof "amount"; and

(iii) by striking out "scetion 217" in subparagraph (C)(ii) and inserting in lieu thereof "section 217".

(B) Section 215(a)(4) of such Act is amended by indenting subparagraph (B) two ems so as to align its left margin with the margin of subparagraph (A) (and by appropriately further indenting clauses (i) and (ii) of such subparagraph (B)).

(C) Section 215(f)(2)(A) of such Act is amended by striking out "primary insurance account" and inserting in lieu thereof "primary insurance amount".

(D) Section 215(h) of such Act is amended—

(i) by adding at the beginning thereof the following heading:

"Service of Certain Public Health Service Officers";

and

(ii) by striking out "Civil Service Commission" in paragraph (1) and inserting in lieu thereof "Director of the Office of Personnel Management".

(E) Section 215 of such Act is further amended—

(i) by striking out "he" each place it appears in subsections (a)(2)(B)(i), (a)(3)(B)(i), (a)(4)(A), (b)(2)(A) (second sentence), (b)(3)(A)(ii)(I), (b)(4), and (f)(2)(D)(ii), and the first place it appears in subsection (f)(2)(A), and inserting in lieu thereof "he or she";

(ii) by striking out "his" each place it appears in subsections (a)(3)(B)(ii), (b)(1)(A), and (b)(2)(B)(ii)(II) and inserting in lieu thereof "his or her";

(iii) by striking out "him" in subsections (d)(1)(C) and (e)(1) and inserting in lieu thereof "such individual"; and

(iv) by striking out "he" the second place it appears in subsection (f)(2)(A) and inserting in lieu thereof "the Secretary".

(11)(A) Section 2203(d)(4) of Public Law 97-35 is amended by inserting after "at the end of paragraph (3)" the following: "(after and below subparagraph (C)(ii))".

(B) Section 216(i)(2)(F)(ii) of the Social Security Act is amended by striking out "enacted," in the matter immediately preceding subdivision (I) and inserting in lieu thereof "enacted—".

(12)(A) Section 217(d) of such Act is amended by indenting paragraphs (1) and (2) two ems.

(B) Section 217(e)(1) of such Act is amended by inserting ", National Oceanic and Atmospheric Administration Corps," after "Coast and Geodetic Survey" in the last sentence.

(C) Section 217(f)(1) of such Act is amended by striking out "Civil Service Commission" and inserting in lieu thereof "Director of the Office of Personnel Management".

(13) Section 218(i) of such Act is amended by striking out "subchapter A or E of chapter 9 of the Internal Revenue Code" and inserting in lieu thereof "chapter 21 and subtitle F of the Internal Revenue Code of 1954".

(14) Section 221(e) of such Act is amended by striking out "Federal Disability Trust Fund is charged" and inserting

in lieu thereof "Federal Disability Insurance Trust Fund is charged".

(15)(A) Subsections (a) and (b)(1) of section 222 of such Act are amended by striking out "the Vocational Rehabilitation Act" each place it appears and inserting in lieu thereof "title I of the Rehabilitation Act of 1973".

(B) Section 222(b)(3) of such Act is amended by striking out "equal" and inserting in lieu thereof "equals".

(C) Section 222(b)(4) of such Act is amended by striking out "full-time student" and inserting in lieu thereof "full-time elementary or secondary school student".

(16)(A) Section 223(d)(2)(A) of such Act is amended by striking out "an individual" and inserting in lieu thereof "An individual".

(B)(i) Section 223 of such Act is further amended by striking out "he" each place the term appears (except in subsection (c)(1)(B)(iii)) and inserting in lieu thereof—

(I) "such individual" in subsections (a)(1) (the first, second, fourth, sixth, and seventh places it appears in the first sentence, and in the second, third, and fourth sentences), (a)(2) (the first, third, and fourth places it appears in the first sentence, and in the second sentence), (c)(1)(A) (the first place it appears), (c)(1)(B)(i), (c)(1)(B)(ii) (the first place it appears), (c)(2)(B) (the first place it appears), (d)(1)(B), (d)(2)(A) (the second and third places it appears), (e), and (g)(2)(A); and

(II) "he or she" in subsections (a)(1) (the third and fifth places it appears), (a)(2) (the second and fifth places it appears), (b), (c)(1)(A) (the second place it appears), (c)(1)(B)(ii) (the second place it appears), (c)(2)(B) (the second place it appears), (d)(2)(A) (the first and fourth places it appears), and (d)(5).

(ii) Section 223 of such Act is further amended by striking out "his" each place the term appears (except in subsection (d)(2)(B)) and inserting in lieu thereof—

(I) "such individual's" in subsections (d)(2)(A) (the first place it appears) and (d)(4) (the second place it appears); and

(II) "his or her" in subsections (a)(1), (a)(2), (d)(2)(A) (the second place it appears), (d)(4) (the first and third places it appears), (e), and (g)(2).

(iii) Section 223 of such Act is further amended by striking out "him" each place the term appears and inserting in lieu thereof—

(I) "such individual" in subsections (d)(2)(A) and (d)(4) (the second place it appears); and

(II) "him or her" in subsection (d)(4) (the first place it appears).

(17) Section 226(b) of such Act is amended (in the matter following paragraph (2)(C)) by striking out "part (A)" and inserting in lieu thereof "part A".

(18) The last sentence of section 230(c) of such Act is amended by striking out "(3)(f)(3)" and inserting in lieu thereof "3(f)(3)".

(b)(1) Section 302(b) of such Act is amended by striking out all that follows "through" and precedes "and prior" and inserting in lieu thereof "the Fiscal Service of the Department of the Treasury".

(2) Section 303(a)(4) of such Act is amended by striking out "1606(b)" and inserting in lieu thereof "3305(b)".

(3) Section 303(a)(5) of such Act (as amended by the 1983 Amendments) is amended—

(A) by striking out "1606(b)" and inserting in lieu thereof "3305(b)"; and

(B) by striking out the punctuation mark immediately before the last proviso and inserting in lieu thereof a colon.

(4) Section 303(c) of such Act is amended by striking out "That" in paragraphs (1) and (2) and inserting in lieu thereof "that".

(5) Section 303(e)(2)(A)(i) of such Act is amended by striking out "child support obligatons" and inserting in lieu thereof "child support obligations".

(c)(1)(A) Section 402(a)(9) of such Act is amended by striking out "use of disclosure" and inserting in lieu thereof "use or disclosure".

(B) Section 402(a)(14) of such Act is amended by striking out "(A) provide that" and inserting in lieu thereof "provide (A) that".

(C) Section 402(a)(19)(F)(i) of such Act is amended by striking out "or section 408" and inserting in lieu thereof "or section 472".

(D) Section 402(a)(19)(G) of such Act is amended by striking out the comma before "that" in clause (iv).

(E) Section 402(a) of such Act is further amended—

(i) by striking out "must" immediately before the first of its 36 numbered subdivisions and inserting in lieu thereof "must—";

(ii) by indenting and aligning such numbered subdivisions (without altering any of the numbering, language, or punctuation) to the extent necessary to make each of such subdivisions a numbered paragraph with its left margin indented two ems (and with any designated internal subdivisions within such paragraphs (including the numbered subdivisions in subparagraphs (A) and (B) of paragraph (8) and in subparagraph (A) of paragraph (14) but not including such subparagraphs themselves, and not including any of the subdivisions in paragraphs (9), (10), (15), (19)(G), (25), (30), (31), (33), and (36)) being appropriately further indented and aligned as subparagraphs or clauses);

(iii) by striking out "and" after the semicolon at the end of paragraph (5);

(iv) by striking out "clause" each place it appears in paragraphs (15)(A), (15)(B), and (19)(F) and inserting in lieu thereof "paragraph"; and

(v) by striking out "section 402(a)(7)" in paragraph (19)(D) and inserting in lieu thereof "paragraph (7)".

(F) Section 402(c) of such Act is amended by striking out "clause" each place it appears and inserting in lieu thereof "paragraph".

(2)(A) Section 403(b)(3) of such Act is amended by striking out all that follows "through" and precedes "and prior" and inserting in lieu thereof "the Fiscal Service of the Department of the Treasury".

(B) Clause (ii) in the last sentence of section 403(j) of such Act is amended by striking out the comma after "excess payments".

(3)(A) Section 406(b)(2) of such Act is amended by adding "and" after the semicolon at the end of clause (C), by striking out clause (D), and by redesignating clause (E) as clause (D).

(B)(i) The last sentence of section 406(b) of such Act, and section 402(a)(19)(F)(i) of such Act, are each amended by striking out "clauses (A) through (E)" and inserting in lieu thereof "clauses (A) through (D)".

(ii) Section 402(a)(26)(B) of such Act is amended by striking out "subparagraphs (A) through (E)" and inserting in lieu thereof "clauses (A) through (D)".

(4)(A) Section 407(b)(1)(C) of such Act is amended by striking out "such father", and "he" each place it appears, and by inserting in lieu thereof in each instance "such parent".

(B) Section 407(b)(2)(A) of such Act is amended by striking out "thirty days" and inserting in lieu thereof "30 days".

(5) Section 409(a) of such Act is amended—

(A) by striking out "vacanies" in paragraph (1)(B) and inserting in lieu thereof "vacancies"; and

(B) by striking out "part (C)" in paragraph (3) and inserting in lieu thereof "part C".

(6) Section 410 of such Act is amended by striking out "Food Stamp Act of 1964" in subsections (a) and (c) and inserting in lieu thereof "Food Stamp Act of 1977".

(7)(A) Section 414(b)(5) of such Act in amended by striking out "receipients" and inserting in lieu thereof "recipients".

(B) Section 415(b)(1)(B)(ii) of such Act is amended by striking out "determinig" and inserting in lieu thereof "determining".

(8) Section 420(b) of such Act is amended by striking out the comma immediately after "preceding sentence".

(9) Section 441 of such Act is amended by striking out "(a)".

(10) Section 444(d) of such Act is amended by striking out "rereferred" and inserting in lieu thereof "referred".

(11) Section 445(b)(1)(E) of such Act is amended by striking out "Comprehensive Employment and Training Act of 1973" and inserting in lieu thereof "Job Training Partnership Act".

(12) The second sentence of section 452(c)(2) of such Act is amended by striking out "preceding section" and inserting in lieu thereof "preceding sentence".

(13) Section 453(b)(2) of such Act is amended by striking out ", or the United States" and inserting in lieu thereof "of the United States".

(14) Section 454 of such Act is amended—

(A) by striking out "of such parent" in paragraph (9)(C);

(B) by striking out "collection and distribution," in clause (A)(ii) of paragraph (16) and inserting in lieu thereof "collection, and distribution"; and

(C) by indenting paragraph (17) two ems so as to align its left margin with the margins of the preceding paragraphs, and amending such paragraph (as so indented)—

(i) by striking out “to accept” and inserting in lieu thereof “provide that the State will accept”,

(ii) by striking out “ and to impose” and inserting in lieu thereof “will impose”,

(iii) by striking out “to transmit” and inserting in lieu thereof ”will transmit”, and

(iv) by striking out “, otherwise to comply” and inserting in lieu thereof “will otherwise comply”.

(15) Section 456 of such Act is amended—

(A) by inserting “(1)” after “Sec. 456. (a)”;

(B) by striking out “(1) The amount” and inserting in lieu thereof “(2) The amount”;

(C) by striking out “(2) Any” and inserting in lieu thereof “(3) Any”; and

(D) by striking out “paragraphs (1)(A) and (B)” and inserting in lieu thereof “subparagraphs (A) and (B) of paragraph (2)”.

(16) The heading of section 458 of such Act is amended by striking out “States” and inserting in lieu thereof “states”.

(17) Section 462(f)(2) of such Act is amended by striking out “dependents” and inserting in lieu thereof “dependents’ ”.

(18)(A) Section 474(b)(4)(A) of such Act is amended by striking out “subparagraph (c)” and inserting in lieu thereof “subparagraph (C)”.

(B) Section 474(c)(2) of such Act is amended by striking out “relvant” and inserting in lieu thereof “relevant”.

(C) Section 474(d)(1) of such Act is amended—

(i) by striking out “and (c)” the second place it appears and inserting in lieu thereof “and (C)”; and

(ii) by striking out “secretary” and inserting in lieu thereof “Secretary”.

(d)(1) Section 901(c) of such Act is amended by aligning paragraphs (1) through (4) (including the subparagraphs in paragraph (3)) flush with the left margin (but with appropriate indentation in the case of the subparagraphs and clauses in paragraph (1)).

(2) Section 901(f) of such Act is amended by moving paragraph (3) two ems to the left, so that its left margin is in flush alignment with the margins of the other paragraphs in such section.

(3) Section 904(b) of such Act is amended by striking out "the Second Liberty Bond Act, as amended," and inserting in lieu thereof "chapter 31 of title 31, United States Code,".

(4) Section 908(d) of such Act is amended by striking out "5703(b)" and inserting in lieu thereof "5703".

(e)(1)(A) Subparagraphs (C) and (D) of section 1101(a)(8) of such Act are amended by indenting them 4 ems so as to align their left margin with the left margin of subparagraphs (A) and (B) of such section.

(B) Paragraph (9) of section 1101(a) of such Act is amended by indenting it (including subparagraphs (A) through (D) and clauses (i) and (ii) of subparagraph (C)) 4 additonal ems so as to align the left margin at the beginning of such paragraph with the left margin of paragraph (8)(A) of such section.

(2)(A) Section 1107(a) of such Act is amended by striking out ", subchapter E of chapter 1 or subchapter A, C, or E of chapter 9 of the Internal Revenue Code,".

(B) The amendment made by subparagraph (A) shall not apply to returns filed or representations made on or before the date of the enactment of this Act.

(3) Section 1107(b) of such Act is amended—

(A) by striking out "he" each place it appears and inserting in lieu thereof "he or she"; and

(B) by striking out "former wife divorced," each place it appears and inserting in lieu thereof "divorced wife, divorced husband, surviving divorced wife, surviving divorced husband, surviving divorced mother, surviving divorced father,".

(4) Section 1114(h)(1) of such Act is amended by striking out "sections 281, 283, and 1914 of title 18 of the United States Code, and section 190 of the Revised Statutes (5 U.S.C. 99)" and insert in lieu thereof "sections 203, 205, and 209 of title 18, United States Code".

(5) Section 1115(a) of such Act is amended by striking out "VI,", "602,", and "603,".

(6) Section 1116 of such Act is amended—

(A) by striking out "VI," in subsections (a)(1), (b), and (d);

(B) by striking out "604," in subsection (a)(3); and

(C) by striking out "XVI," and all that follows through "part A" in subsection (d) and inserting in lieu thereof "XVI, or XIX, or part A".

(7) Section 1131(a) of such Act is amended—

(A) by striking out the period after "section 204(d) of this Act" in paragraph (2)(B) and inserting in lieu thereof a comma; and

(B) by moving the matter following paragraph (2)(B) two ems to the left so that it is flush with the left margin.

(f) Title XIII of such Act is repealed.

(g)(1) Section 1611(c) of such Act is amended by adding at the beginning thereof the following heading:

"Period for Determination of Benefits".

(2) Section 1611(g) of such Act is amended by striking out "or individuals" and inserting in lieu thereof "or such individual".

(3) Section 1612(b)(2) of such Act is amended by indenting subparagraph (B) two ems so as to align its left margin with the margin of subparagraph (A).

(4) Section 1612(b)(9) of such Act is amended by inserting a comma after "child".

(5) The heading of section 1613(c) of such Act is amended to read as follows:

"Disposal of Resources For Less Than Fair Market Value".

(6) Section 1614(a)(3) of such Act is amended by moving subparagraph (E) two ems to the left, so that its left margin is in flush alignment with the margins of the other subparagraphs in such section.

(7) Section 1614(d)(1) of such Act is amended by striking out "man and women" and inserting in lieu thereof "man and woman".

(8) Section 1615 of such Act is amended by striking out "the Vocational Rehabilitation Act" in subsections (a), (c), and (d) and inserting in lieu thereof "title I of the Rehabilitation Act of 1973".

(9) Section 1618 of such Act is amended—

(A) by moving subsection (d) two ems to the left, so that its left margin is in flush alignment with the margins of the other subsections in such section;

(B) by striking out the comma after "levels of its" in such subsection (d); and

(C) by inserting a comma after "1980", and after "1976" each place it appears, in such subsection.

(10) Section 1621(e) of such Act is amended by striking out "severably" and inserting in lieu thereof "severally".

(11) Section 1631(b)(1) of such Act is amended by striking out "equity or" and inserting in lieu thereof "equity and".

(12) Section 1631(d)(1) of such Act is amended by striking out "(e), and (f)" and inserting in lieu thereof "and (e)".

(h)(1) Section 2002(b) of such Act is amended by striking out "section 203 of the Intergovernmental Cooperation Act of 1968 (42 U.S.C. 4213)" and inserting in lieu thereof "section 6503 of title 31, United States Code,".

(2) Section 2006(c) of such Act is amended by striking out "section 202 of the Intergovernmental Cooperation Act

of 1968 (42 U.S.C. 4212)" and inserting in lieu thereof "section 6503 of title 31, United States Code".

(i)(1) Subsection (f) of section 86 of the Internal Revenue Code of 1954 is amended by redesignating paragraphs (1), (2), (3), and (4) as paragraphs (2), (3), (4), and (5), respectively, and by inserting before paragraph (2) (as so redesignated) the following new paragraph:

"(1) section 37(c)(3)(A) (relating to reduction for amounts received as pension or annuity),".

(2) Subsection (a) of section 132 of such Code is amended by striking out paragraphs (6) and (7) and by redesignating paragraph (8) as paragraph (6).

(3) Section 3121(b)(1) of such Code is amended by striking out "(A)" and all that follows down through "or (B)".

(4)(A) Section 3121(b)(5)(B) of such Code (as amended by section 101(b)(1) of the 1983 Amendments) is amended to read as follows:

"(B) is performed by an individual who—

"(i) has been continuously performing service described in subparagraph (A) since December 31, 1983, and for purposes of this clause—

"(I) if an individual performing service described in subparagraph (A) returns to the performance of such service after being separated therefrom for a period of less than 366 consecutive days, regardless of whether the period began before, on, or after December 31, 1983, then such service shall be considered continuous,

"(II) if an individual performing service described in subparagraph (A) returns to the performance of such service after being detailed or transferred to an international organization as described under section 3343 of subchapter III of chapter 33 of title 5, United States Code, or under section 3581 of chapter 35 of such title, then the service performed for that organization shall be considered service described in subparagraph (A),

"(III) if an individual performing service described in subparagraph (A) is reemployed or reinstated after being separated from such service for the purpose of accepting employment with the American Institute in Taiwan as provided under section 3310 of chapter 48 of title 22, United States Code, then the service performed for that Institute shall be considered service described in subparagraph (A), and

"(IV) if an individual performing service described in subparagraph (A) returns to the performance of such service after performing service as a member of a uniformed service (including, for purposes of this clause, service in the National Guard and temporary service in the Coast Guard Reserve) and after exercising restoration or reemployment rights as provided under chapter 43 of title 38, United States Code, then the service so performed as a member of a uniformed service shall be considered service described in subparagraph (A); or

"(ii) is receiving an annuity from the Civil Service Retirement and Disability Fund, or benefits (for service as an employee) under another retirement system established by a law of the United States for employees of the Federal Government (other than for members of the uniformed service);".

(B) Section 3121(b)(5)(v) of such Code (as so amended) is amended to read as follows:

"(v) any other service in the legislative branch of the Federal Government if such service—

"(I) is performed by an individual who was not subject to subchapter III of chapter 83 of title 5, United States Code, or to another retirement system established by a law of the United States for employees of the Federal Government (other than for members of the uniformed services), on December 31, 1983, or

"(II) is performed by an individual who was subject to subchapter III of chapter 83 of such title 5, or to another retirement system established by a law of the United States for employees of the Federal Government (other than for members of the uniformed services), on December 31, 1983, but who—

"(a) commenced the performance of such service in the legislative branch after that date, or

"(b) was separated from service in the legislative branch after that date and has returned to the performance of such service, unless such individual becomes subject to such subchapter III within 45 days after the effective date of such commencement or return (or, if later, within 45 days after the date of the enactment of this subclause), or remains subject to such other retirement system, and unless (in the case of a separation and return described in subdivision (b)) the period of the separation was less than 366 consecutive days;

and for purposes of this clause (v) an individual is subject to such subchapter III or to any such other retirement system at any time only if (1) such individual's pay is subject to deductions, contributions, or similar payments (concurrent with the service being performed at that time) under section 8334(a) of such title 5 or the corresponding provision of the law establishing such other system, or (in a case to which section 8332(k)(1) of such title applies) such individual is making payments of amounts equivalent to such deductions, contributions, or similar payments while on leave without pay, or (2) such individual is receiving an annuity from the Civil Service Retirement and Disability Fund, or is receiving benefits (for service as an employee) under another retirement system established by a law of the United States for employees of the Federal Government (other than for members of the uniformed services);".

(C) The amendments made by subparagraphs (A) and (B) shall be effective with respect to service performed after December 31, 1983.

(5) Section 3121(i)(2) of such Code is amended by striking out "section 102(10) of the Servicemen's and Veterans' Survivor Benefits Act" and inserting in lieu thereof "chapter 3 and section 1009 of title 37, United States Code".

(6) Section 3121(m)(2) of such Code is amended—

(A) by striking out "section 102 of the Servicemen's and Veterans' Survivor Benefits Act" and inserting in lieu thereof "paragraph (21) of section 101 of title 38, United States Code"; and

(B) by striking out "such section" and inserting in lieu thereof "paragraph (22) of such section".

(7) Section 3121(m)(3) of such Code is amended by striking out "such section 102" and inserting in lieu thereof "paragraph (23) of such section 101".

(8) Section 3121(n) of such Code is amended—

(A) by striking out "a reserve component of a uniformed service as defined in section 102(3) of the Servicemen's and Veterans' Survivor Benefits Act" in the first sentence and inserting in lieu thereof "a reserve component as defined in section 101(27) of title 38, United States Code";

(B) by inserting ", the National Oceanic and Atmospheric Administration Corps," after "Coast and Geodetic Survey" in the first sentence;

(C) by striking out "military or naval" each place it appears in paragraph (5) and inserting in lieu thereof "military, naval, or air"; and

(D) by striking out "Universal Military Training and Service Act" in paragraph (5)(B) and inserting in lieu thereof "Military Selective Service Act".

(9) Effective January 1, 1984, subparagraph (B) of section 3121(v)(1) of such Code is amended to read as follows:

"(B) any amount treated as an employer contribution under section 414(h)(2) where the pickup referred to in such section is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise).".

(10) Effective January 1, 1985, subparagraph (B) of section 3306(r)(1) of such Code is amended to read as follows:

"(B) any amount treated as an employer contribution under section 414(h)(2) where the pickup referred to in such section is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise).".

(11) Section 6334(c) of such Code is amended by inserting "(including section 207 of the Social Security Act)" immediately after "any other law of the United States".

(j)(1) Section 1101(a)(6) of the Social Security Act is amended by striking out "means" and all that follows and inserting in lieu thereof "means the Secretary of Health and Human Services.".

(2) The following provisions of such Act are amended by striking out "Health, Education, and Welfare" wherever it appears and inserting in lieu thereof "Health and Human Services":

(A) In title II—

(i) subsections (a)(3), (a)(4), (b)(1), (b)(2), (g)(1), (g)(2), (g)(4), and (i)(1) of section 201;

(ii) subsections (q)(4)(B), (q)(6)(B), and (r)(1) of section 218; and

(iii) subsections (b)(3) and (b)(4) of section 231;

(B) in title IV—

(i) subsections (b)(2) and (b)(3) of section 403;

(ii) subsection (a) of section 431;

(iii) subsection (b) of section 436;

(iv) section 439;

(v) section 441;

(vi) section 443;

(vii) subsection (a) of section 444;

(viii) subsection (a) of section 452;

(ix) subsection (b)(1) of section 453;

(x) paragraph (8)(B) of section 454; and

(xi) section 460;

(C) in title VII—

(i) section 702; and

(ii) subsection (c)(1) of section 706;

(D) in title XI—

(i) section 1102;

(ii) subsection (b) of section 1106;

(iii) subsection (b) of section 1107;

(iv) subsection (c) of section 1114;

(v) section 1120; and

(vi) subsection (a) of section 1126;

(E) in title XVI, section 1602; and

(F) in title XVIII—

(i) subsections (a), (f)(1), (g), and (h) of section 1817;

(ii) subsections (a)(2) and (d)(1) of section 1840;

(iii) subsections (f), (g), (h), and (i) of section 1841; and

(iv) subsection (b)(3) of section 1842.

(3) The following provisions of such Act are amended by striking out "of Health, Education, and Welfare" wherever it appears:

(A) In title II—

(i) subsections (a)(10)(B) and (l)(4)(A) of section 210;

(ii) subsections (a)(2), (a)(3), (b)(2), (e)(2), (e)(3), and (f)(1) of section 217;

(iii) subsections (a)(1), (c)(4), (d)(3), (d)(7), (h)(2), (h)(3), (i), (j), (k)(1), (l), and (p)(2) of section 218;

(iv) subsection (g) of section 228; and

(v) subsection (d) of section 233;

(B) in title IV—

(i) subsection (a)(3) of section 403; and

(ii) subsection (e) of section 407; and

(C) in title XIX, section 1901.

(4) Section 205(l) of such Act is amended by striking out "employee" and all that follows down through "designated" and inserting in lieu thereof "employee of the Department of Health and Human Services designated".

(5) The following provisions of the Internal Revenue Code of 1954 are amended by striking out "Health, Education, and Welfare" each place it appears and inserting in lieu thereof "Health and Human Services":

(A) Subsection (d)(6)(B)(ii) of section 51;

(B) subsections (c)(1), (c)(2)(E), (g)(1), (g)(3)(A), and (g)(3)(B) of section 1402;

(C) subsection (b)(10)(B) of section 3121;

(D) subsections (d) and (f) of section 6057;

(E) subsection (l)(5) of section 6103; and

(F) paragraph (5) of section 6511(d).

(k) Sections 432(d), 432(f)(1), 433(g), and 434(b) of the Social Security Act are each amended by striking out "of Labor" wherever it appears.

(l) Any reference to the Federal Security Administrator which may remain in the provisions of title II, IV, VII, or XI of the Social Security Act (other than section 1101(a)(6) of such Act) is amended—

(1) by substituting "Secretary" or "Secretary's" for the term "Administrator" or "Administrator's", where the reference is to that term alone;

(2) by substituting "Secretary of Health, Education, and Welfare" for the term "Federal Security Administrator", where the reference is to that term, if the provision containing such reference is amended by paragraph (2) or (3) of subsection (j) (in which case the amendment of such provision under this paragraph shall be deemed to have taken effect immediately prior to the amendment of such provision under such paragraph (2) or (3)); and

(3) by substituting "Secretary of Health and Human Services" for the term "Federal Security Administrator" in any other case where the reference is to that term;

but nothing in this subsection shall affect the exercise under section 402(a)(5) of such Act of the functions, powers, and duties relating to the prescription of personnel standards on a merit basis which were transferred from the Secretary of Health, Education, and Welfare by section 208(a)(3)(D) of Public Law 91–648.

SEC. 644. EFFECTIVE DATES.

(a) The amendments made by sections 641 and 642 shall be effective as though they had been included in the enactment of the Social Security Amendments of 1983 (Public Law 98–21).

(b) Except to the extent otherwise specifically provided in this subtitle, the amendments made by section 643 shall be effective on the date of the enactment of this Act; but none of such amendments shall be construed as changing or affecting any right, liability, status, or interpretation which existed (under the provisions of law involved) before that date.

PART II—CHANGES IN MEDICARE-RELATED PROVISIONS OF THE SOCIAL SECURITY ACT

SEC. 646. CHANGES IN MEDICARE PROVISIONS RELATING TO THE 1983 AMENDMENTS.

(a)(1) Section 1866(a)(1)(F) of the Social Security Act is amended by inserting "a professional standards review organization (if there is such an organization in existence in the area in which the hospital is located as of July 1, 1983) or" before "a utilization and quality control".

(2) The amendment made by paragraph (1) shall take effect on the sixtieth day following the date of the enactment of this Act.

(b)(1) Section 1886(d)(1) of such Act is amended—

(A) by striking out ", or discharges occurring" in subparagraph (C), and

(B) by striking out "cost reporting periods beginning, or" in subparagraph (D).

(2) Section 1886(c)(4)(A) of such Act is amended by striking out "and (D)" and inserting in lieu thereof "(D) and (E)".

(3) Section 1886(e)(5) of such Act is amended—

(A) by striking out "for public comment" in the matter before subparagraph (A), and

(B) by inserting "for public comment" in subparagraph (A) after "that fiscal year,".

(4) Section 1866(a)(1)(F) of such Act (as added by section 602(f)(1)(C) of the Social Security Amendments of 1983 (in this part referred to as the "1983 Amendments") is amended by striking out "(c) or (d)" and inserting in lieu thereof "(b), (c), or (d)".

(5)(A) The last sentence of section 1878(f)(1) of such Act is amended by inserting "or which have obtained a hearing under subsection (b)" after "common ownership or control".

(B) The amendment made by subparagraph (A) shall be effective with respect to any appeal or action brought on or after the date of the enactment of this Act.

(6) Section 1818(c) of such Act is amended by striking out "subsection (a) of section 1839" and inserting in lieu thereof "subsection (b) of section 1839".

(c)(1) Section 1817(a) of the Social Security Act (as amended by section 141(b) of the 1983 Amendments) is amended—

(A) by striking out "monthly on the first day of each calendar month" in the next to last sentence and inserting in lieu thereof "from time to time",

(B) by striking out "to be paid to or deposited into the Treasury during such month" in such sentence and inserting in lieu thereof "paid to or deposited into the Treasury", and

(C) by striking out the last sentence.

(2) The amendments made by paragraph (1) shall become effective on the first day of the month following the month in which this Act is enacted.

(d)(1) Section 602(h)(2) of the Social Security Amendments of 1983 (Public Law 98–21) is amended by adding at the end the following new subparagraph:

"(C) Notwithstanding section 604(a)(1), the amendments made by this paragraph shall be effective with respect to any appeal or action brought on or after the date of the enactment of the Tax Reform Act of 1984.".

(2) Section 604(c) of such Amendments is amended by adding at the end the following new paragraph:

"(4) The Secretary shall cause to be published in the Federal Register proposed regulations to carry out subsection

(c) of section 1886 of the Social Security Act (as amended by this title) no later than May 1, 1984, and allow for a period of 45 days for public comment thereon. After consideration of the comments received, the Secretary shall cause to be published in the Federal Register final regulations to carry out such subsection not later than August 1, 1984.".

(e) Except as otherwise specifically provided in this section, the amendments made by this section shall be effective as though they had been included in the enactment of the Social Security Amendments of 1983 (Public Law 98-21).

SEC. 647. ENROLLMENT AND PREMIUM PENALTY WITH RESPECT TO WORKING AGED PROVISION.

(a) The second sentence of section 1839(b) of the Social Security Act is amended by adding before the period at the end the following: ", but there shall not be taken into account months in which the individual has met the conditions specified in clauses (i) and (iii) of section 1862(b)(3)(A) and can demonstrate that the individual was enrolled in a group health plan described in clause (iv) of such section by reason of the individual's (or the individual's spouse's) current employment".

(b) Section 1837 of such Act is amended by adding at the end the following new subsection:

"(i)(1) In the case of an individual who—

"(A) meets the conditions described in clauses (i) and (iii) of section 1862(b)(3)(A),

"(B) at the time the individual first satisfies paragraph (1) or (2) of section 1836, is enrolled in a group health plan described in section 1862(b)(3)(A)(iv) by reason of the individual's (or the individual's spouse's) current employment, and

"(C) has elected not to enroll (or to be deemed enrolled) under this section during the individual's initial enrollment period,

there shall be a special enrollment period described in paragraph (3).

"(2) In the case of an individual who—

"(A) meets the conditions described in clauses (i) and (iii) of section 1862(b)(3)(A),

"(B)(i) has enrolled (or has been deemed to have enrolled) in the medical insurance program established under this part during the individual's initial enrollment period and any subsequent special enrollment period under this subsection during which the individual was not enrolled in a group health plan described in section 1862(b)(3)(A)(iv) by reason of the individual's (or individual's spouse's) current employment, and

"(C) has not terminated enrollment under this section at any time at which the individual is not enrolled in such a group health plan by reason of the individual's (or individual's spouse's) current employment,

there shall be a special enrollment period described in paragraph (3).

"(3) The special enrollment period referred to in paragraphs (1) and (2) is the period—

"(A) beginning with the first day of the third month before the month in which the individual attains the age of 70 and ending seven months later, or

"(B) beginning with the first day of the first month in which the individual is no longer enrolled in a group health plan described in section 1862(b)(3)(A)(iv) by reason of current employment and ending seven months later,

whichever period begins earlier.".

(c) Section 1838 of such Act is amended by adding at the end the following new subsection:

"(e) Notwithstanding subsection (a), in the case of an individual who enrolls during a special enrollment period pursuant to—

"(1) subparagraph (A) of section 1837(i)(3)—

"(A) before the month in which he attains the age of 70, the coverage period shall begin on the first day of the month in which he has attained the age of 70, or

"(B) in or after the month in which he attains the age of 70, the coverage period shall begin on the first day of the month following the month in which he so enrolls; or

"(2) subparagraph (B) of section 1837(i)(3)—

"(A) in the first month of the special enrollment period, the coverage period shall begin on the first day of such month, or

"(B) in a month after the first month of the special enrollment period, the coverage period shall begin on the first day of the month following the month in which he so enrolls.".

(d)(1) The amendment made by subsection (a) shall apply to months beginning with January 1983 for premiums for months beginning with July 1984.

(2) The amendments made by subsections (b) and (c) shall apply to enrollments in months beginning with July 1984, except that in the case of any individual who would have had a special enrollment period under section 1837(i) of the Social Security Act that would have begun before July 1, 1984, such period shall be deemed to begin on July 1, 1984.

SEC. 648. OTHER TECHNICAL CORRECTIONS IN MEDICARE-RELATED PROVISIONS OF THE SOCIAL SECURITY ACT AND RELATED ACTS.

(a)(1) Section 1122(b) of the Social Security Act is amended—

(A) by striking out the period at the end of paragraph (1) and inserting in lieu thereof a comma, and

(B) by striking out "(or the Mental Retardation Facilities and Community Mental Health Centers Construction Act of 1963)".

(2) Section 1122(i)(3) of such Act is amended by striking out "5703(b)" and inserting in lieu thereof "5703".

(3) Section 1128A(g) of such Act is amended by striking out "Professional Standards Review Organization" and inserting in lieu thereof "utilization and quality control peer review organization".

(4) Section 1129(a) of such Act is amended by striking out "Sate" and inserting in lieu thereof "State".

(5) The heading of title XI of such Act is amended by striking out "PROFESSIONAL STANDARDS REVIEW" and inserting in lieu thereof "PEER REVIEW".

(b)(1) The last sentence of sections 1814(a) of such Act and the last sentence of section 1835(a) of such Act are each amended by striking out "contractural" and inserting in lieu thereof "contractual".

(2) Sections 1817(c) and 1841(c) of such Act are each amended by striking out "under the Second Liberty Bond Act, as amended" and inserting in lieu thereof "under chapter 31 of title 31, United States Code".

(3) Section 1818(c)(1) of such Act is amended by striking out "Act" and inserting in lieu thereof "section".

(4) Section 1818(d)(2) of such Act is amended by striking out "if midway between multiples of $1" and inserting in lieu thereof ", if a multiple of 50 cents but not a multiple of $1,".

(5) Section 1833(a)(2) of such Act is amended by indenting subparagraphs (A) and (B) two additional ems so as to align their left margins with the left margin of subparagraph (C) and by appropriately further indenting the clauses and subclauses of such subparagraphs.

(6) Section 1832(a)(2)(F)(ii)(II) of such Act is amended by striking out "Organization" and inserting in lieu thereof "organization".

(7) Section 1833(a)(1) of such Act is amended by striking out "and" at the end thereof.

(8) Section 1835(a)(2) of such Act is amended—

(A) by striking out "and" at the end of subparagraphs (B) and (C), and

(B) by indenting subparagraph (D) two additional ems so as to align its left margin with the left margin of subparagraph (C).

(9) Section 1835(e) of such Act is amended—

(A) by inserting "(i)" in paragraph (2) after "written assurances that",

(B) by striking out "(B)" in paragraph (2) and inserting in lieu thereof "(ii)',

(C) by striking out "return for" in paragraph (2) and inserting in lieu thereof "return of", and

(D) by striking out "(1) such hospital" and "(2) the Secretary" and inserting in lieu thereof "(A) such hospital" and "(B) the Secretary", respectively.

(10) Section 1837(g)(1) of such Act is amended by striking out "section 226(a)(2)(B)" and "section 1839(e)" and inserting in lieu thereof "section 226(b)" and "section 1839(d)", respectively.

(11) Sections 1840(d)(1), 1840(d)(2), and 1841(h) of such Act are each amended by striking out "Civil Service Commission" and inserting in lieu thereof "Director of the Office of Personnel Management" each place it appears.

(12) Section 1841(h) of such Act is amended by striking out "it" and inserting in lieu thereof "the Director".

(13) Section 1842(b)(3)(B)(ii)(II) of such Act is amended by striking out the period following "title".

(14) The seventh sentence of section 1842(b) of such Act is amended by striking out "(i)" and "(ii)" and inserting in lieu thereof "(I)" and "(II)", respectively.

(15) Section 1842(h)(3) of such Act is amended by striking out "lowest charged" and insert in lieu thereof "lowest charge".

(16) Section 1843(d)(3)(B) of such Act is amended by striking out "1937" and inserting in lieu thereof "1974".

(17) Section 1844(a)(1)(B)(ii) of such Act is amended by striking out the period and inserting in lieu thereof "; plus".

(18) Sections 1864(c) and 1875(b) of such Act are each amended by striking out "the" after "Joint Commission on".

(19) Section 1861(j)(2) of such Act is amended by striking out "provision of" and inserting in lieu thereof "provision for".

(20) Section 1861(j)(13) of such Act is amended by striking out "a nursing home" and inserting in lieu thereof "an institution".

(21) Section 1861(u) of such Act is amended by striking out "or" before "home health agency".

(22) Section 1861(v)(1) of such Act is amended—

(A) by redesignating the clause (B) in subparagraph (A) as subparagraph (B) with the first line of such subparagraph indented 2 ems;

(B) by aligning subparagraphs (C) and (D) flush with the left margin (but with appropriate indentation in the case of the clauses and subclauses of subparagraph (C)); and

(C) by inserting a comma after "section 1832(a)(2)(B)(i)" in subparagraph (D).

(23) Section 1861(v)(1)(C)(i) of such Act is amended by inserting a dash after "but only if".

(24) Section 1861(v)(1)(E)(ii) of such Act is amended by striking out "uses" and inserting in lieu thereof "use".

(25) Section 1861(v)(1)(I) of such Act is amended by striking out "to the Secretary, or upon request to the Comptroller General" in clauses (i) and (ii) and inserting in lieu thereof "by the Secretary, or upon request by the Comptroller General".

(26) Section 1861(v)(3) of such Act is amended by striking out "semiprivate" and inserting in lieu thereof "semi-private".

(27) Section 1861(z)(2) of such Act is amended by striking out "subparagraph (1)" and inserting in lieu thereof "paragraph (1)".

(28) Section 1861(aa)(2)(I) of such Act is amended by striking out "ultilization" and inserting in lieu thereof "utilization".

(29) Section 1861(cc)(1)(F) of such Act is amended by striking out "self administered" and inserting in lieu thereof "self-administered".

(30) Section 1861(cc)(2)(F) of such Act is amended by striking out "standard establishment" and inserting in lieu thereof "standards established".

(31) Section 1862(a)(12) of such Act is amended by striking out the second comma after "dental procedure".

(32) Section 1862(b)(3)(A)(iii) of such Act is amended by inserting "before the month" after "ending with the month".

(33) Section 1863 of such Act is amended by striking out "(j)(11)" and inserting in lieu thereof "(j)(15)".

(34) Section 1866(a)(1)(E) of such Act is amended by adding at the end a comma.

(35) Section 1866(b) of such Act is amended by moving the alignment of paragraph (3) two ems to the left so as to align its left margin with the left margin of paragraph (4).

(36) Section 1869(b)(1)(B) of such Act is amended by striking out ", or section 1818, or section 1819" and inserting in lieu thereof "or section 1818".

(37) Section 1872 of such Act is amended—

(A) by striking out the comma after "206", and

(B) by striking out "(f),".

(38) Section 1876(b)(2)(D) of such Act is amended by striking out "paragraph (1)" and inserting in lieu thereof "subparagraph (A)".

(39) Section 1876(c)(4)(A)(i) of such Act is amended by striking out "promptly as appropriate" and inserting in lieu thereof "with reasonable promptness".

(40) Section 1878(c) of such Act is amended by striking out "inadmissable" and inserting in lieu thereof "inadmissible".

(41) Section 1878(e) of such Act is amended by striking out ", (e), and (f)" and inserting in lieu thereof "and (e)".

(42) Section 1881 of such Act is amended by striking out "end-stage" and inserting in lieu thereof "end stage" each place it appears.

(43) Section 1886(a)(2)(B) of such Act is amended by striking out "disportionate" and inserting in lieu thereof "disproportionate".

(44) Section 1886(b)(3)(A)(ii) of such Act is amended by inserting "of" after "in the case".

(45) Section 1886(d)(3)(D)(i)(I) of such Act is amended by striking out "(C)," and inserting in lieu thereof "(C))".

(c)(1)(A) Section 903(a)(4) of Public Law 96–499 is amended by striking out "new paragraph".

(B) Section 937(c) of Public Law 96–499 is amended by striking out "on on" and inserting in lieu thereof "on or".

(2) Section 2353(h)(1) of Public Law 97-35 is amended by striking out the comma after "XIX".

(3)(A) Section 114(c)(2)(C)(ii) of Public Law 97-248 is amended by inserting "and enrolled under part B" after "part A".

(B) Section 114(c)(3)(E) of Public Law 97-248 is amended—

(i) by striking out "section 1833(a)(1) of the Social Security Act or", and

(ii) by adding before the period at the end the following: ", or reimbursement on a reasonable cost basis under section 1833(a)(1)(A) of such Act".

(C) Section 149 of Public Law 97-248 is amended by striking out "part" and inserting in lieu thereof "subtitle".

(d) Section 162(i)(2) of the Internal Revenue Code of 1954 is amended by striking out "213(e)" and inserting in lieu thereof "213(d)".

(e)(1) Except as provided in paragraph (2), the amendments made by this section shall be effective on the date of the enactment of this Act; but none of such amendments shall be construed as changing or affecting any right, liability, status, or interpretation which existed (under the provisions of law involved) before that date.

(2) The amendments made by paragraphs (1), (2), and (3) of subsection (c) shall be effective as if they had been

originally included in Public Laws 96-499, 97-35, and 97-248, respectively.

TITLE VII—TAX-EXEMPT BOND PROVISIONS

SEC. 701. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This title may be cited as the "Tax-Exempt Bond Limitation Act of 1984".

(b) TABLE OF CONTENTS.—

TITLE VII—TAX-EXEMPT BOND PROVISIONS

Sec. 701. Short title; table of contents.

Subtitle A—Mortgage Subsidy Bonds

Sec. 711. Extension of mortgage subsidy bond authority.
Sec. 712. Mortgage credit certificates.

Subtitle B—Private Activity Bonds

Sec. 721. Limitation on aggregate amount of private activity bonds.
Sec. 722. Tax exemption denied for obligation directly or indirectly guaranteed by Federal Government.
Sec. 723. Aggregate limit per taxpayer for small issue exception.
Sec. 724. Limitations on acquisitions of land, existing facilities, etc.
Sec. 725. Miscellaneous industrial development bond provisions.
Sec. 726. Effective dates.

Subtitle C—Obligations of Certain Educational Organizations

Sec. 731. Tax-exempt status of obligations of certain educational organizations.

Subtitle A—Mortgage Subsidy Bonds

SEC. 711. EXTENSION OF MORTGAGE SUBSIDY BOND AUTHORITY.

(a) GENERAL RULE.—Subparagraph (B) of section 103A(c)(1) (defining qualified mortgage bond) is amended by striking out "December 31, 1983" each place it appears and inserting in lieu thereof "December 31, 1988".

(b) REPORTING REQUIREMENTS FOR MORTGAGE SUBSIDY BONDS.—

(1) IN GENERAL.—Subsection (j) of section 103A (relating to other requirements) is amended by adding at the end thereof the following new paragraph:

"(3) INFORMATION REPORTING REQUIREMENT.—

"(A) IN GENERAL.—An issue meets the requirements of this subsection only if the issuer submits to the Secretary, not later than the 15th day of the 2nd calendar month after the close of the calendar quarter in which the issue is issued, a statement concerning the issue which contains—

"(i) the name and address of the issuer,

"(ii) the date of the issue, the amount of the lendable proceeds of the issue, and the stated interest rate, term, and face amount of each obligation which is part of the issue,

"(iii) such information as the Secretary may require in order to determine whether such issue meets the requirements of this section, and

"(iv) such other information as the Secretary may require.

"(B) EXTENSION OF TIME.—The Secretary may grant an extension of time for the filing of any statement under subparagraph (A) if there is reasonable cause for the failure to file such statement in a timely fashion."

(2) REQUIREMENT TO APPLY TO VETERANS' BONDS.—Subparagraph (C) of section 103A(c)(3) (defining qualified veterans' mortgage bond) is amended by striking out "subsection (j)(1)" and inserting in lieu thereof "paragraphs (1) and (3) of subsection (j)".

(c) TREATMENT OF QUALIFIED VETERANS' BONDS.—

(1) TERMINATION OF TREATMENT.—Paragraph (3) of section 103A(c) (defining qualified veterans' mortgage bond) is amended by adding at the end thereof the following new sentence: "No obligation issued after December 31, 1988, may be treated as a qualified veterans' mortgage bond."

(2) STATE CEILING REDUCED BY AMOUNT OF VETERANS' BONDS.—Paragraph (4) of section 103A(g) (defining State ceiling) is amended to read as follows:

"(4) STATE CEILING.—For purposes of this section—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the State ceiling applicable to any State for any calendar year shall be the greater of—

"(i) 9 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences located within the jurisdiction of such State, or

"(ii) $200,000,000.

"(B) REDUCTION FOR AMOUNT OF QUALIFIED VETERANS' MORTGAGE BONDS ISSUED DURING PRECEDING CALENDAR YEAR.—The State ceiling applicable to any State for any calendar year shall be reduced by the aggregate amount of qualified veterans' mortgage bonds issued in the State during the preceding calendar year."

(d) TREATMENT OF LIMITED EQUITY COOPERATIVES.—

(1) IN GENERAL.—Section 103A(l) (relating to other definitions and special rules) is amended by adding at the end thereof the following new paragraph:

"(11) TREATMENT OF LIMITED EQUITY COOPERATIVE HOUSING CORPORATIONS.—

"(A) TREATMENT AS RESIDENTIAL RENTAL PROPERTY.—Except as provided in subparagraph (B), for purposes of this section and section 103(b), any limited equity cooperative housing shall be treated as residential rental property and not as owner-occupied housing.

"(B) SUBJECT TO MORTGAGE SUBSIDY BOND CEILING.—

"(i) IN GENERAL.—In the case of any issue a significant portion of the proceeds of which are to be used to finance limited equity cooperative housing—

"(I) subsection (a) of section 103 shall not apply to any obligation issued as a part of such issue unless such issue meets the requirements of subsection (g) of this section, and

"(II) for purposes of subsection (g) of this section, any obligation issued as a part of such issue shall be treated as a qualified mortgage bond.

"(ii) EXCEPTION WHERE FINANCING SUBJECT TO SECTION 103 CAP.—Clause (i) shall not apply to any obligation which was taken into account under section 103(n).

"(C) LIMITED EQUITY COOPERATIVE HOUSING.—For purposes of this paragraph, the term 'limited equity cooperative housing' means any dwelling unit which a person is entitled to occupy by reason of his ownership of stock in a qualified cooperative housing corporation.

"(D) QUALIFIED COOPERATIVE HOUSING CORPORATION.—For purposes of this paragraph, the term 'qualified cooperative housing corporation' means any cooperative housing corporation (as defined by section 216(b)(1)) if—

"(i) the consideration paid for stock held by any stockholder entitled to occupy any house or apartment in a building owned or leased by the corporation may not exceed the sum of—

"(I) the consideration paid for such stock by the first such stockholder, as adjusted by a cost-of-living adjustment determined by the Secretary,

"(II) payments made by any stockholder for improvements to such house or apartment,

"(III) payments attributable to any stockholder to amortize the principal of the corporation's indebtedness arising from the acquisition or development of real property, including improvements, thereto, and

"(IV) contributions attributable to any stockholder to a corporate reserve account to the extent that such account is restricted to the development or acquisition of real property, including improvements, thereto;

"(ii) the value of the corporation's assets, to the extent such value exceeds the combined transfer values of the outstanding corporate stock (reduced by any corporate liabilities), shall be used only for public benefit or charitable purposes, or directly to benefit the corporation itself, and shall not be used directly to benefit any stockholder; and

"(iii) such corporation makes an election under this paragraph at such time and in such manner as the Secretary may by regulations prescribe.

"(E) EFFECT OF ELECTION.—If a cooperative housing corporation makes an election under this paragraph, section 216 shall not apply with respect to such corporation (or any successor thereof).

"(F) CORPORATION MUST CONTINUE TO BE LIMITED EQUITY COOPERATIVE.—Subsection (b)(4)(A) of section 103 shall not apply to any obligation issued as part of an issue a significant portion of the proceeds of which are to be used to finance limited equity cooperative housing unless the cooperative housing corporation continues to be a qualified cooperative housing corporation at all times during the qualified project period (within the meaning of section 103(b)(12)(B)).

"(G) ELECTION IRREVOCABLE.—Any election under this paragraph, once made, shall be irrevocable."

(e) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply with respect to obligations issued after December 31, 1983.

(2) TRANSITIONAL RULE WHERE STATE FORMULA FOR ALLOCATING STATE CEILING EXPIRES.—

(A) IN GENERAL.—If a State law which provided a formula for allocating the State ceiling under section 103A(g) of the Internal Revenue Code of 1954 for calendar year 1983 expires as of the close of calendar year 1983, for purposes of section 103A(g) of such Code, such State law shall be treated as remaining in effect after 1983. In any case to which the preceding sentence applies, where the State's expiring allocation formula requires action by a State official to allocate the State ceiling among issuers, actions of such State official in allocating such ceiling shall be effective.

(B) TERMINATION.—Subparagraph (A) shall not apply on or after the effective date of any State legislation enacted after the date of the enactment of this Act with respect to the allocation of the State ceiling.

(3) QUALIFIED VETERANS' MORTGAGE BONDS AUTHORIZED BEFORE OCTOBER 18, 1983, NOT TAKEN INTO ACCOUNT.—For purposes of section 103A(g)(4)(B) of the Internal Revenue Code of 1954 (as amended by this section), any qualified veterans' mortgage bond shall not be taken into account if—

(A) The issuance of such bond was authorized by a State referendum before October 18, 1983, or

(B) the issuance of such bond is authorized pursuant to a State referendum before December

1, 1983, where such referendum was authorized by action of the State legislature before October 18, 1983.

SEC. 712. MORTGAGE CREDIT CERTIFICATES.

(a) IN GENERAL.—Subpart A of part IV of subchapter A of chapter 1 (relating to credits against tax) is amended by redesignating section 25 as section 26 and by inserting after section 24 the following new section:

"SEC. 25. INTEREST ON CERTAIN HOME MORTGAGES.

"(a) ALLOWANCE OF CREDIT.—There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the product of—

"(1) the certificate credit rate, and

"(2) the interest paid or incurred by the taxpayer during the taxable year on the remaining principal of the certified indebtedness amount.

"(b) CERTIFICATE CREDIT RATE; CERTIFIED INDEBTEDNESS AMOUNT.—For purposes of this section—

"(1) CERTIFICATE CREDIT RATE.—The term 'certificate credit rate' means the rate of the credit allowable by this section which is specified in the mortgage credit certificate.

"(2) CERTIFIED INDEBTEDNESS AMOUNT.—The term 'certified indebtedness amount' means the amount of indebtedness which is—

"(A) incurred by the taxpayer—

"(i) to acquire the principal residence of the taxpayer,

"(ii) as a qualified home improvement loan (as defined in section 103A(l)(6)) with respect to such residence, or

"(iii) as a qualified rehabilitation loan (as defined in section 103A(l)(7)) with respect to such residence, and

"(B) specified in the mortgage credit certificate.

"(c) MORTGAGE CREDIT CERTIFICATE; QUALIFIED MORTGAGE CREDIT CERTIFICATE PROGRAM.—For purposes of this section—

"(1) MORTGAGE CREDIT CERTIFICATE.—The term 'mortgage credit certificate' means any certificate which—

"(A) is issued under a qualified mortgage credit certificate program by the State or political subdivision having the authority to issue a qualified mortgage bond to provide financing on the principal residence of the taxpayer,

"(B) is issued to the taxpayer in connection with the acquisition, qualified rehabilitation, or qualified home improvement of the taxpayer's principal residence,

"(C) specifies—

"(i) the certificate credit rate, and

"(ii) the certified indebtedness amount, and

"(D) is in such form as the Secretary may prescribe.

"(2) QUALIFIED MORTGAGE CREDIT CERTIFICATE PROGRAM.—

"(A) IN GENERAL.—The term 'qualified mortgage credit certificate program' means any program—

"(i) which is established by a State or political subdivision thereof for any calendar year for which it is authorized to issue qualified mortgage bonds,

"(ii) under which the issuing authority elects (in such manner and form as the Secretary may prescribe) not to issue an amount of qualified mortgage bonds which it may otherwise issue during such calendar year under section 103A,

"(iii) under which the indebtedness certified by mortgage credit certificates meets the requirements of the following subsections of section 103A (as modified by subparagraph (B) of this paragraph):

"(I) subsection (d) (relating to residence requirements),

"(II) subsection (e) (relating to 3-year requirement),

"(III) subsection (f) (relating to purchase price requirement),

"(IV) subsection (h) (relating to portion of loans required to be placed in targeted areas), and

"(V) paragraphs (1) and (2) of subsection (j) (relating to other requirements),

"(iv) under which no mortgage credit certificate may be issued with respect to any residence any of the financing of which is provided from the proceeds of a qualified mortgage bond,

"(v) which is not limited to indebtedness incurred from particular lenders, and

"(vi) if the issuing authority allocates a block of mortgage credit certificates for use in connection with a particular development, which requires the developer to furnish to the issuing authority and the homebuyer a certificate that the price for the residence is no higher than it would be without the use of a mortgage credit certificate.

"(B) MODIFICATIONS OF SECTION 103A.—Under regulations prescribed by the Secretary, in applying section 103A for purposes of subclauses (II) and (IV) of subparagraph (A)(iii)—

"(i) each qualified mortgage certificate credit program shall be treated as a separate issue,

"(ii) the product determined by multiplying—

"(I) the certified indebtedness amount of each mortgage credit certificate issued under such program, by

"(II) the certificate credit rate specified in such certificate,

shall be treated as proceeds of such issue and the sum of such products shall be treated as the total proceeds of such issue, and

"(iii) paragraph (1) of section 103A(e) shall be applied by substituting '100 percent' for '90 percent or more'.

Clause (iii) shall not apply if the issuing authority submits a plan to the Secretary for administering the 90-percent requirement of section 103A(e)(1) and the Secretary is satisfied that such requirement will be met under such plan.

"(d) Determination of Certificate Credit Rate.—For purposes of this section—

"(1) In general.—The certificate credit rate specified in any mortgage credit certificate shall not be less than 10 percent or more than 50 percent.

"(2) Aggregate limit on certificate credit rates.—

"(A) In general.—In the case of each qualified mortgage credit certificate program, the sum of the products determined by multiplying—

"(i) the certified indebtedness amount of each mortgage credit certificate issued under such program, by

"(ii) the certificate credit rate with respect to such certificate,

shall not exceed 15 percent of the nonissued bond amount.

"(B) Nonissued bond amount.—For purposes of subparagraph (A), the term 'nonissued bond amount' means, with respect to any qualified mortgage credit certificate program, the amount of qualified mortgage bonds which the issuing authority is otherwise authorized to issue and elects not to issue under subsection (c)(2)(A)(ii).

"(C) AGGREGATE OF NONISSUED BOND AMOUNTS CANNOT EXCEED 9 PERCENT OF MORTGAGES EXECUTED.—The aggregate nonissued bond amount for any calendar year of all issuing authorities in any State shall not exceed the limit determined under section 103A(g)(4)(A)(i) for such State for such calendar year.

"(e) SPECIAL RULES AND DEFINITIONS.—For purposes of this section—

"(1) CARRYFORWARD OF UNUSED CREDIT.—In the case of any taxpayer, if the credit allowable under subsection (a) for any taxable year exceeds the limitation imposed by section 26(a) for such year reduced by the sum of the credits allowable under this subpart (other than this section) such excess shall be carried to the succeeding taxable year and added to the credit allowable under subsection (a) for such succeeding taxable year.

"(2) INDEBTEDNESS NOT TREATED AS CERTIFIED WHERE CERTAIN REQUIREMENTS NOT IN FACT MET.—Subsection (a) shall not apply to any indebtedness if all the requirements of subsection (d)(1), (e), (f), and (j) of section 103A were not in fact met with respect to such indebtedness.

"(3) PERIOD FOR WHICH CERTIFICATE IN EFFECT.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), a mortgage credit certificate shall be treated as in effect with respect to interest attributable to the period—

"(i) beginning on the date such certificate is issued, and

"(ii) ending on the earlier of the date on which—

"(I) the certificate is revoked by the issuing authority, or

"(II) the residence to which such certificate relates ceases to be the principal residence of the individual to whom the certificate relates.

"(B) CERTIFICATE INVALID UNLESS INDEBTEDNESS INCURRED WITHIN CERTAIN PERIOD.—A certificate shall not apply to any indebtedness which is incurred after the close of the calendar year following the calendar year for which the issuing authority made the applicable election under subsection (c)(2)(A)(ii).

"(C) NOTICE TO SECRETARY WHEN CERTIFICATE REVOKED.—Any issuing authority which revokes any mortgage credit certificate shall notify the Secretary of such revocation at such time and in such manner as the Secretary shall prescribe by regulations.

"(4) SPECIAL RULES WHERE MORTGAGE IS ASSUMED.—In the case of a mortgage with respect to which a mortgage credit certificate was issued and which is assumed by a taxpayer—

"(A) the credit certificate rate under such certificate shall not be taken into account under this section to the extent it exceeds 25 percent, and

"(B) such certificate shall be treated as issued to such taxpayer.

"(5) CERTAIN REFINANCING PERMITTED.—In applying subsection (c)(2)(A)(iii), the requirements of section 103A(j)(1) shall be treated as met if a mortgage credit certificate is issued with respect to a mortgage which is used to replace an existing mortgage for which such a certificate has already been issued if, under regulations prescribed by the Secretary, such replacement mortgage does not extend the term, alter the amortization schedule, or increase the principal amount, of the original mortgage.

"(6) PUBLIC NOTICE THAT CERTIFICATES WILL BE ISSUED.—At least 90 days before any mortgage credit certificate is to be issued after a qualified mortgage credit certificate program, the issuing authority shall provide reasonable public notice of—

"(A) the eligibility requirements for such certificate,

"(B) the methods by which such certificates are to be issued, and

"(C) such other information as the Secretary may require.

"(7) INTEREST PAID OR ACCRUED TO RELATED PERSONS.—No credit shall be allowed under subsection (a) for any interest paid or accrued to a person who is a related person to the taxpayer (within the meaning of section 103(b)(6)(C)(i)).

"(8) PRINCIPAL RESIDENCE.—The term 'principal residence' has the same meaning as when used in section 1034.

"(9) QUALIFIED REHABILITATION AND HOME IMPROVEMENT.—

"(A) QUALIFIED REHABILITATION.—The term 'qualified rehabilitation' has the meaning given such term by section 103A(l)(7)(B).

"(B) QUALIFIED HOME IMPROVEMENT.—The term 'qualified home improvement' means an alteration, repair, or improvement described in section 103A(l)(6).

"(10) QUALIFIED MORTGAGE BOND.—The term 'qualified mortgage bond' has the meaning given such term by section 103A(c)(1).

"(f) REDUCTION IN AGGREGATE AMOUNT OF QUALIFIED MORTGAGE BONDS WHICH MAY BE ISSUED WHERE CERTAIN REQUIREMENTS NOT MET.—

"(1) IN GENERAL.—If for any calendar year any mortgage credit certificate program fails to meet the requirements of—

"(A) clause (iii), (iv), (v), or (vi) of subsection (c)(2)(A), or

"(B) paragraph (2) of subsection (d),

the applicable State ceiling under paragraph (4) of section 103A(g) for the State in which such program operates shall be reduced by twice the correction amount with respect to such failure. Such reduction shall be applied to such State ceiling for the calendar year following the calendar year in which the Secretary determines the correction amount with respect to such failure.

"(2) CORRECTION AMOUNT.—

"(A) IN GENERAL.—For purposes of paragraph (1), the term 'correction amount' means, in the case of a failure to meet a requirement referred to in—

"(i) paragraph (1)(A), the amount of indebtedness involved, or

"(ii) paragraph (1)(B), the amount equal to the excess credit amount divided by 0.15.

"(B) EXCESS CREDIT AMOUNT.—

"(i) IN GENERAL.—For purposes of subparagraph (A)(ii), the term 'excess credit amount' means the excess of—

"(I) the credit amount for any mortgage credit certificate program, over

"(II) the amount which would have been the credit amount for such program had such program met the requirements of paragraph (2) of subsection (d).

"(ii) CREDIT AMOUNT.—For purposes of clause (i), the term 'credit amount' means the sum of the products determined under clauses (i) and (ii) of subsection (d)(2)(A).

"(3) SPECIAL RULE FOR STATES HAVING CONSTITUTIONAL HOME RULE CITIES.—In the case of a State having one or more constitutional home rule cities (within the meaning of section 103A(g)(5)(C)), the reduction in the State ceiling by reason of paragraph (1) shall be allocated to the constitutional home rule city, or to the portion of the State not within such city, whichever caused the reduction.

"(g) REPORTING REQUIREMENTS.—Each person who makes a loan which is a certified indebtedness amount under any mortgage credit certificate shall file a report with the Secretary containing—

"(1) the name, address, and social security account number of the individual to which the certificate was issued,

"(2) the certificate's issuer, date of issue, certified indebtedness amount, and certificate credit rate, and

"(3) such other information as the Secretary may require by regulations.

Such report shall be filed at such time and in such manner as the Secretary may require by regulations.

"(h) TERMINATION.—No election may be made under subsection (c)(2)(A)(ii) for any calendar year after 1988."

(b) APPLICATION WITH SECTION 103A.—Subsection (g) of section 103A (relating to limitation on aggregate amount of qualified mortgage bonds issued during any calendar year) is amended by adding at the end thereof the following new paragraph:

"(8) REDUCTION FOR MORTGAGE CREDIT CERTIFICATES.—The applicable limit of any issuing authority for any calendar year shall be reduced by the sum of—

"(A) the amount of qualified mortgage bonds which such authority elects not to issue under section 25(c)(2)(A)(ii) during such year, plus

"(B) the amount of any reduction in such ceiling under section 25(f) applicable to such authority for such year."

(c) DISALLOWANCE OF PORTION OF DEDUCTION FOR INTEREST WHERE CREDIT TAKEN.—Section 163 (relating to deduction for interest) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) REDUCTION OF DEDUCTION WHERE SECTION 25 CREDIT TAKEN.—The amount of the deduction under this section for interest paid or accrued during any taxable year on indebtedness with respect to which a mortgage credit certificate has been issued under section 25 shall be reduced by the amount of the credit allowable with respect to such interest under section 25 (determined without regard to section 26)."

(d) PENALTY FOR FAILURE TO FILE REPORTS.—

(1) IN GENERAL.—Subchapter B of chapter 68 is amended by adding at the end thereof the following new section:

"SEC. 6706. FAILURE TO FILE REPORTS ON LOANS COVERED BY MORTGAGE CREDIT CERTIFICATES.

"(a) IN GENERAL.—Any person required by section 25(g) to file a report with the Secretary who fails to file the report with respect to any mortgage credit certificate at the time and in the manner required by the Secretary shall pay a penalty of $200 for such failure unless it is shown that such failure is due to reasonable cause and not to willful neglect.

"(b) DEFICIENCY PROCEDURES NOT TO APPLY.—Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) shall not apply with respect to the assessment or collection of any penalty imposed by subsection (a)."

(2) CLERICAL AMENDMENT.—The table of sections for such subchapter B is amended by adding at the end thereof the following new item:

"Sec. 6706. Failure to file reports on loans covered by mortgage credit certificates."

(e) ALLOCATION TO ISSUERS OTHER THAN STATE HOUSING FINANCING AGENCIES DETERMINED ON BASIS OF POPULATION WHERE NO OVERRIDING STATE STATUTE.—Subparagraph (A) of section 103A(g)(3) is amended by striking out all that follows "for such year as—" and inserting in lieu thereof:

"(i) the population of the jurisdiction of such issuing authority, bears to

"(ii) the population for the entire State.

For purposes of the preceding sentence, the determination of population shall be made in accordance with section 103(n)(9)."

(f) TECHNICAL AMENDMENTS.—

(1) Sections 28(d)(2), 29(b)(5), 30(g)(1)(A), 38(c)(2), and 901(a), as amended by this Act, are each amended by striking out "section 25(b)" and inserting in lieu thereof "section 26(b)".

(2) Section 23(b)(5), as amended by this Act, is amended by striking out "section 25(a)" and inserting in lieu thereof "section 26(a)" and by striking out "(other than this section)" and inserting in lieu thereof "(other than this section and section 25)".

(3) Paragraph (3) of section 55(c) is amended—

(A) by striking out "25" each place it appears and inserting in lieu thereof "26", and

(B) by striking out "section 23, 30, or 38" and inserting in lieu thereof "section 23, 25, 30, or 38".

(4) Clause (iii) of section 168(i)(1)(D), as added by section 208(a) of the Tax Equity and Fiscal Responsibility Act of 1982 and amended by this Act, is amended by striking out "section 25(b)(2)" and inserting in lieu thereof "section 26(b)(2)".

(5) Clause (iii) of section 168(i)(1)(D), as added by section 209(b) of the Tax Equity and Fiscal Responsibility Act of 1982 and amended by this Act, is amended by striking out "section 25(b)(2)" and inserting in lieu thereof "section 26(b)(2)".

(g) CONFORMING AMENDMENT.—The table of sections for subpart A of part IV of subchapter A of chapter 1 is amended by striking out the item relating to section 25 and inserting in lieu thereof the following:

"Sec. 25. Interest on certain home mortgages.
"Sec. 26. Limitation based on tax liability; definition of tax liability."

(h) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to interest paid or accrued after December 31, 1983, on indebtedness incurred after December 31, 1983.

(2) ELECTIONS.—The amendments made by this section shall apply to elections under section 25(c)(2)(A)(ii) of the Internal Revenue Code of 1954 (as added by this section) for calendar years after 1983.

(3) SUBSECTION (e).—The amendment made by subsection (e) shall apply to obligations issued after December 31, 1984.

(4) TRANSITIONAL RULE RELATING TO AMOUNT OF CERTIFICATES WHICH MAY BE ISSUED.—

(A) IN GENERAL.—If the aggregate amount of mortgage subsidy bonds issued by any authority during 1983 was less than the applicable limit of such authority under section 103A(g) of the Internal Revenue Code of 1954 for such calendar year, then, for purposes of section 25(d)(2) of such Code, the nonissued bond amount with respect to any qualified mortgage credit certificate program (determined without regard to this paragraph) for calendar year 1984, 1985, 1986, 1987, or 1988 shall be reduced by the excess of the applicable limit of such authority for such calendar year over the amount determined under subparagraph (B) or (C).

(B) 1984.—For calendar year 1984, the sum of—

(i) the aggregate amount of mortgage subsidy bonds issued by the issuing authority during 1983, plus

(ii) 25 percent of the excess of the applicable limit of such authority for 1984 over the amount determined under clause (i).

(C) 1985, 1986, 1987, 1988.—For calendar year 1985, 1986, 1987, or 1988, the sum of—

(i) the amount determined for the preceding calendar year under this subparagraph or subparagraph (B), plus

(ii) 25 percent of the excess of the applicable limit of such authority for the calendar year over the amount determined under clause (i).

Subtitle B—Private Activity Bonds

SEC. 721. LIMITATION ON AGGREGATE AMOUNT OF PRIVATE ACTIVITY BONDS.

Section 103 (relating to interest on certain governmental obligations) is amended by redesignating subsection (n) as subsection (o) and by inserting after subsection (m) the following new subsection:

"(n) LIMITATION ON AGGREGATE AMOUNT OF PRIVATE ACTIVITY BONDS ISSUED DURING ANY CALENDAR YEAR.—

"(1) IN GENERAL.—A private activity bond issued as part of an issue shall be treated as an obligation not described in subsection (a) if the aggregate amount of private activity bonds issued pursuant to such issue, when added to the aggregate amount of private activity bonds previously issued by the issuing authority during the calendar year, exceeds such authority's private activity bond limit for such calendar year.

"(2) PRIVATE ACTIVITY BOND LIMIT FOR STATE AGENCIES.—For purposes of this subsection—

"(A) IN GENERAL.—The private activity bond limit for any agency of the State authorized to issue private activity bonds for any calendar year shall be 50 percent of the State ceiling for such calendar year.

"(B) SPECIAL RULE WHERE STATE HAS MORE THAN 1 AGENCY.—If more than 1 agency of the State is authorized to issue private activity bonds, all such agencies shall be treated as a single agency.

"(3) PRIVATE ACTIVITY BOND LIMIT FOR OTHER ISSUERS.—For purposes of this subsection—

"(A) IN GENERAL.—The private activity bond limit for any issuing authority (other than a State agency) for any calendar year shall be an amount which bears the same ratio to 50 percent of the State ceiling for such calendar year as—

"(i) the population of the jurisdiction of such issuing authority, bears to

"(ii) the population for the entire State.

"(B) OVERLAPPING JURISDICTIONS.—For purposes of subparagraph (A)(i), the rules of section 103A(g)(3)(B) shall apply.

"(4) STATE CEILING.—For purposes of this subsection—

"(A) IN GENERAL.—The State ceiling applicable to any State for any calendar year shall be an amount equal to $150 multiplied by the State's population.

"(B) PHASEIN OF LIMITATION WHERE AMOUNT OF 1983 PRIVATE ACTIVITY BONDS EXCEEDS THE CEILING.—

"(i) IN GENERAL.—In the case of any State which had an excess bond amount for 1983, the State ceiling for calendar year

1984 shall be the sum of the State ceiling determined under subparagraph (A) plus 50 percent of the excess bond amount for 1983.

"(ii) EXCESS BOND AMOUNT FOR 1983.—For purposes of clause (i), the excess bond amount for 1983 in any State is the excess (if any) of—

"(I) the aggregate amount of private activity bonds issued by issuing authorities in such State during the first 9 months of calendar year 1983 multiplied by 4/3, over

"(II) the State ceiling determined under subparagraph (A) for calendar year 1984.

"(C) ADJUSTMENT OF CEILING TO REFLECT TERMINATION OF SMALL ISSUE EXEMPTION.—In the case of calendar years after 1983, subparagraph (A) shall be applied by substituting '$100' for '$150'.

"(5) SPECIAL RULE FOR STATES WITH CONSTITUTIONAL HOME RULE CITIES.—In the case of any State with 1 or more constitutional home rule cities (as defined in section 103A(g)(5)(C)), the rules of paragraph (5) of section 103A(g) shall apply for purposes of this subsection.

"(6) STATE MAY PROVIDE FOR DIFFERENT ALLOCATION.—

"(A) IN GENERAL.—A State may, by law enacted after the date of the enactment of this subsection, provide a different formula for allocating the State ceiling among the governmental units in such State having authority to issue private activity bonds.

"(B) INTERIM AUTHORITY FOR GOVERNOR.—

"(i) IN GENERAL.—The Governor of any State may proclaim a different formula for allocating the State ceiling among the governmental units in such State having authority to issue private activity bonds.

"(ii) TERMINATION OF AUTHORITY.—The authority provided in clause (i) shall not apply after the earlier of—

"(I) the first day of the first calendar year beginning after the legislature has met in regular session for more than 60 days after the date of the enactment of this paragraph, or

"(II) the effective date of any State legislation with respect to the allocation of the State ceiling enacted after the date of the enactment of this subsection.

"(C) STATE MAY NOT ALTER ALLOCATION TO CONSTITUTIONAL HOME RULE CITIES.—The rules of paragraph (6)(C) of section 103A(g) shall apply for purposes of this paragraph.

"(7) PRIVATE ACTIVITY BOND.—For purposes of this subsection—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, the term 'private activity bond' means any obligation the interest on which is exempt from tax under subsection (a) and which is—

"(i) an industrial development bond, or

"(ii) a student loan bond.

"(B) EXCEPTION FOR MULTIFAMILY HOUSING.—The term 'private activity bond' shall not include any obligation described in subsection (b)(4)(A) nor any public housing program obligation under section 11(b) of the United States Housing Act of 1937.

"(C) EXCEPTION FOR CERTAIN FACILITIES DESCRIBED IN SECTION 103(b)(4) (C) OR (D).—

"(i) IN GENERAL.—The term 'private activity bond' shall not include any obligation described in subparagraph (C) or (D) of section 103(b)(4), but only if the property described in such subparagraph is owned by a governmental unit.

"(ii) EXCEPTION NOT TO APPLY TO CERTAIN PARKING FACILITIES.—This subparagraph shall not apply to any obligation described in subparagraph (D) of section 103(b)(4) solely by reason of the reference to parking facilities contained therein.

"(D) REFUNDING ISSUES.—The term 'private activity bond' shall not include any obligation which is issued to refund another obligation to the extent that the amount of such obligation does not exceed the amount of the refunded obligation. In the case of any student loan bond, the preceding sentence shall apply only if the maturity date of the refunding obligation is not later than the later of—

"(i) the maturity date of the obligation to be refunded, or "(ii) the date 15 years after the date on which the refunded obligation was issued (or in the case of a series of refundings, the date on which the original obligation was issued).

"(8) STUDENT LOAN BONDS.—For purposes of this subsection, the term 'student loan bond' means an obligation which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly to finance loans to individuals for educational expenses.

"(9) POPULATION.—For purposes of this subsection, determinations of the population of any State (or issuing authority) shall be made with respect to any calendar year on the basis of the most recent census estimate of the resident population of such State (or issuing authority) published by the Bureau of the Census before the beginning of such calendar year.

"(10) ELECTIVE CARRYFORWARD OF UNUSED LIMITATION FOR SPECIFIED PROJECT.—

"(A) IN GENERAL.—If—

"(i) an issuing authority's private activity bond limit for any calendar year after 1983, exceeds "(ii) the aggregate amount of private activity bonds issued during such calendar year by such authority,

such authority may elect to treat all (or any portion) of such excess as a carryforward for 1 or more carryforward projects.

"(B) ELECTION MUST SPECIFY PROJECT.— In any election under subparagraph (A), the issuing authority shall—

"(i) specify the project (or projects) for which the carryforward is elected, and

"(ii) specify the portion of the excess described in subparagraph (A) which is to be a carryforward for each such project.

"(C) USE OF CARRYFORWARD.—

"(i) IN GENERAL.—If any issuing authority elects a carryforward under subparagraph (A) with respect to any carryforward project, any private activity bonds issued by such authority with respect to such project during the 3 calendar years (or, in the case of a project described in subsection (b)(4)(F), 6 calendar years) following the calendar year in which the carryforward arose shall not be taken into account under paragraph (1) to the extent the amount of such bonds do not exceed the amount of the carryforward elected for such project.

"(ii) ORDER IN WHICH CARRYFORWARD USED.—Carryforwards elected with respect to any project shall be used in the order of the calendar years in which they arose.

"(D) ELECTION.—Any election made under this paragraph shall be made at such time and in such manner as the Secretary shall by regulations prescribe. Any such election (and any specification contained therein), once made, shall be irrevocable.

"(E) CARRYFORWARD PROJECT.—For purposes of this paragraph, the term 'carryforward project' means—

"(i) any project described in paragraph (4) or (5) of subsection (b), and

"(ii) the purpose of issuing student loan bonds.

"(11) TREATMENT OF QUALIFIED SCHOLARSHIP FUNDING BONDS.—In the case of a qualified scholarship funding bond (as defined in subsection (e)), such bond shall be treated for purposes of this subsection as issued by a State or local issuing authority (whichever is appropriate)."

SEC. 722. TAX EXEMPTION DENIED WHERE OBLIGATION DIRECTLY OR INDIRECTLY GUARANTEED BY FEDERAL GOVERNMENT.

Subsection (h) of section 103 (relating to certain obligations must not be guaranteed or subsidized under a energy program) is amended to read as follows:

"(h) OBLIGATION MUST NOT BE GUARANTEED, ETC.—

"(1) IN GENERAL.—An obligation shall not be treated as an obligation described in subsection (a) if such obligation is federally guaranteed.

"(2) FEDERALLY GUARANTEED DEFINED.—For purposes of paragraph (1), an obligation is federally guaranteed if—

"(A) the payment of principal or interest with respect to such obligation is guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof),

"(B) such obligation is issued as part of an issue and a significant portion of the proceeds of such issue are to be—

"(i) used in making loans the payment of principal or interest with respect to which are to be guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof), or

"(ii) invested (directly or indirectly) in federally insured deposits or accounts, or

"(C) the payment of principal or interest on such obligation is otherwise indirectly guaranteed (in whole or in part) by the United States (or an agency or instrumentality thereof).

"(3) EXCEPTIONS.—

"(A) CERTAIN INSURANCE PROGRAMS.—An obligation shall not be treated as federally guaranteed by reason of—

"(i) any guarantee by the Federal Housing Administration, the Veterans' Administration, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association,

"(ii) any guarantee of student loans and any guarantee by the Student Loan Marketing Association to finance student loans, or

"(iii) any guarantee by the Small Business Administration of obligations described in subsection (b)(4)(F).

"(B) DEBT SERVICE, ETC.—Paragraph (1) shall not apply to—

"(i) proceeds of the issue invested for an initial temporary period until such proceeds are needed for the purpose for which such issue was issued,

"(ii) investments of a bona fide debt service fund,

"(iii) investments of a reserve which meet the requirements of subsection (c)(4)(B),

"(iv) investments in obligations issued by the United States Treasury, or

"(v) other investments permitted under regulations.

"(C) EXCEPTION FOR HOUSING PROGRAMS.—

"(i) IN GENERAL.—Except as provided in clause (ii), paragraph (1) shall not apply to—

"(I) an obligation described in subsection (b)(4)(A) or a public housing program obligation under section 11(b) of the United States Housing Act of 1937,

"(II) a qualified mortgage bond (as defined in section 103A(c)(1)), or

"(III) a qualified veterans' mortgage bond (as defined in section 103A(c)(3)).

"(ii) EXCEPTION NOT TO APPLY WHERE OBLIGATION INVESTED IN FEDERALLY INSURED DEPOSITS OR ACCOUNTS.—Clause (i) shall not apply to any obligation which is federally guaranteed within the meaning of paragraph (2)(B)(ii).

"(D) LOANS TO, OR GUARANTEES BY, FINANCIAL INSTITUTIONS.—Except as provided in paragraph (2)(B)(ii), an obligation which is issued as part of an issue shall not be treated as federally guaranteed merely by reason of the fact that the proceeds of such issue are used in making loans to a financial institution or there is a guarantee by a financial institution.

"(4) DEFINITIONS.—For purposes of this subsection—

"(A) TREATMENT OF CERTAIN ENTITIES WITH AUTHORITY TO BORROW FROM UNITED STATES.—To the extent provided in regulations prescribed by the Secretary, any entity with statutory authority to borrow from the United States shall be treated as an instrumentality of the

United States. Except in the case of a private activity bond (as defined in subsection (n)(7)), nothing in the preceding sentence shall be construed as treating the District of Columbia or any possession of the United States as an instrumentality of the United States.

"(B) FEDERALLY INSURED DEPOSIT OR ACCOUNT.—The term 'federally insured deposit or account' means any deposit or account in a financial institution to the extent such deposit or account is insured under Federal law by the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, the National Credit Union Administration, or any similar federally chartered corporation.

"(5) CERTAIN OBLIGATIONS SUBSIDIZED UNDER ENERGY PROGRAM.—

"(A) IN GENERAL.—An obligation to which this paragraph applies shall be treated as an obligation not described in subsection (a) if the payment of the principal or interest with respect to such obligation is to be made (in whole or in part) under a program of the United States, a State, or a political subdivision of a State the principal purpose of which is to encourage the production or conservation of energy.

"(B) OBLIGATIONS TO WHICH PARAGRAPH APPLIES.—This paragraph shall apply to any obligations to which paragraph (1) of subsection (b) does not apply by reason of—

"(i) subsection (b)(4)(H) (relating to qualified hydroelectric generating facilities), or

"(ii) subsection (g) (relating to qualified steam-generating or alcohol-producing facilities)."

SEC. 723. AGGREGATE LIMIT PER TAXPAYER FOR SMALL ISSUE EXCEPTION.

Subsection (b) of section 103 (relating to industrial development bonds) is amended by adding at the end thereof the following new paragraph:

"(15) AGGREGATE LIMIT PER TAXPAYER FOR SMALL ISSUE EXCEPTION.—

"(A) IN GENERAL.—Paragraph (6) of this subsection shall not apply to any issue if the aggregate authorized face amount of such issue allocated to any beneficiary (when increased by the outstanding tax-exempt IDB's of such beneficiary) exceeds $40,000,000.

"(B) Outstanding tax-exempt IDB's of any person.—For purposes of applying subparagraph (A) with respect to any issue, the outstanding tax-exempt IDB's of any person who is a beneficiary with respect to such issue is the aggregate face amount of all industrial development bonds the interest on which is exempt from tax under subsection (a)—

"(i) which are allocated to such beneficiary, and

"(ii) which are outstanding at the time of such later issue (not including as outstanding any obligation which is to be redeemed from the proceeds for the later issue).

"(C) Allocation of amount of issue.—

"(i) Amount allocated to developer, etc.—The amount of any issue shall be allocated to any person who is a beneficiary by reason of owning the facilities being financed by the issue and renting such facilities to other persons to the extent (and only to the extent) the amount of such issue is not allocated under clause (ii).

"(ii) Allocation to other beneficiaries.—The amount of any issue shall be allocated among beneficiaries who are not described in clause (i) as follows:

"(I) If one of such beneficiaries uses more than 50 percent of the facilities, the entire amount of the issue shall be allocated to such beneficiary.

"(II) In any case to which subclause (I) does not apply, the amount of such issue shall be allocated equally among beneficiaries who use at least 25 percent but not more than 50 percent of the facilities; except that no one such person shall be allocated more than 50 percent.

"(D) BENEFICIARY.—For purposes of this paragraph, the term 'beneficiary' means any person who is a user of the facilities being financed by the issue.

"(E) TREATMENT OF RELATED PERSONS.—For purposes of this paragraph, all persons who are related (within the meaning of paragraph (6)(C)) to each other shall be treated as one person."

SEC. 724. LIMITATIONS ON ACQUISITIONS OF LAND, EXISTING FACILITIES, ETC.

(a) LIMITATION ON USE FOR LAND ACQUISITION.—Subsection (b) of section 103 is amended by adding at the end thereof the following new paragraph:

"(16) LIMITATION ON USE FOR LAND ACQUISITION.—

"(A) IN GENERAL.—Paragraphs (4), (5), (6), and (7) shall not apply with respect to any obligation issued as part of an issue if—

"(i) any portion of the proceeds of such issue are to be used (directly or indirectly) for the acquisition of land (or an interest therein) to be used for farming purposes, or

"(ii) 25 percent or more of the proceeds of such issue are to be used (directly or indirectly) for the acquisition of land not described in clause (i) (or an interest therein).

"(B) EXCEPTION FOR FIRST-TIME FARMERS.—

"(i) IN GENERAL.—If the requirements of clause (ii) are met with respect to any land, subparagraph (A) shall not apply to such land, and paragraph (17) shall not apply to property located thereon, but only to the extent of expenditures (financed with the proceeds of the issue) not in excess of $250,000.

"(ii) ACQUISITION BY FIRST-TIME FARMERS.—The requirements of this clause are met with respect to any land if—

"(I) such land is to be used for farming purposes, and

"(II) such land is to be acquired by an individual who is a first-time farmer, who will be the principal user of such land, and who will materially and substantially participate on the farm of which such land is a part in the operation of such farm.

"(iii) FIRST-TIME FARMER.—For purposes of this subparagraph, the term 'first-time farmer' means any individual if such individual has not at any time had any direct or indirect ownership interest in land which is part of a farm in the operation of which such individual materially participated. For purposes of this subparagraph, any ownership or material participation by an individual's spouse or minor child shall be treated as ownership and material participation by the individual.

"(iv) FARM.—For purposes of this subparagraph, the term 'farm' has the meaning given such term by section 6420(c)(2)."

(b) ACQUISITION OF EXISTING PROPERTY NOT PERMITTED.—Subsection (b) of section 103 (relating to industrial development bonds) is amended by adding at the end thereof the following new paragraph:

"(17) ACQUISITION OF EXISTING PROPERTY NOT PERMITTED.—

"(A) IN GENERAL.—Paragraphs (4), (5), (6), and (7) shall not apply to any obligation issued as part of an issue if any portion of the proceeds of such issue is to be used for the acquisition of any property (or an interest therein) unless the first use of such property is pursuant to such acquisition.

"(B) EXCEPTION FOR CERTAIN REHABILITATIONS.—Subparagraphs (A) shall not apply with respect to any building (and the equipment therefor) if—

"(i) the rehabilitation expenditures with respect to such building equals or exceeds "(ii) 15 percent of the cost of acquiring such building (and such equipment).

"(C) REHABILITATION EXPENDITURES.—For purposes of this paragraph—

"(i) IN GENERAL.—Except as provided in this subparagraph, the term 'rehabilitation expenditures' means any amount properly chargeable to capital account which is incurred by the person acquiring the building (or any successor) for property (or additions or improvements to property) in connection with the rehabilitation of a building. In the case of an integrated operation contained in a building before its acquisition, such term includes rehabilitating existing equipment in such building or replacing it with substantially similar equipment.

"(ii) CERTAIN EXPENDITURES NOT INCLUDED.—The term 'rehabilitation expenditures' does not include any expenditure described in section 48(g)(2)(B) (other than clause (i) thereof).

"(iii) PERIOD DURING WHICH EXPENDITURES MUST BE INCURRED.—The term 'rehabilitation expenditures' shall not include any amount which is incurred after the date 2 years after the later of—

"(I) the date on which the building was acquired, or

"(II) the date on which the obligation was issued."

(c) USE OF TAX-EXEMPT BONDS PROHIBITED FOR SKYBOXES, AIRPLANES, GAMBLING ESTABLISHMENTS, ETC.—Subsection (b) of section 103 (relating to industrial development bonds) is amended by adding at the end thereof the following new paragraph:

"(18) NO PORTION OF BONDS MAY BE ISSUED FOR SKYBOXES, AIRPLANES, GAMBLING ESTABLISHMENTS, ETC.—Paragraphs (4), (5), (6), and (7) shall not apply to any obligation issued as part of an issue if any portion of the proceeds of such issue is to be used to provide any airplane, skybox, or other private luxury box, any facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises."

SEC. 725. MISCELLANEOUS INDUSTRIAL DEVELOPMENT BOND PROVISIONS.

(a) CERTAIN RESTRICTIONS APPLY TO EXEMPTIONS NOT CONTAINED IN INTERNAL REVENUE CODE OF 1954.—Paragraph (1) of section 103(m) (relating to obligations exempt other than under this title) is amended by adding at the end thereof the following new sentence: "In the case of an obligation issued after December 31, 1983, such obligation shall not be treated as described in this paragraph unless the appropriate requirements of subsections (b), (c), (h), (k), (l), and (n) of this section and section 103A are met with respect to such obligation. For purposes of applying such requirements, a possession of the United States shall be treated as a State."

(b) EXPANSION OF TAX-EXEMPT BOND FINANCED PROPERTY REQUIRED TO BE DEPRECIATED ON STRAIGHT-LINE BASIS.—

(1) IN GENERAL.—Subparagraph (C) of section 168(f)(12) (relating to limitations on property financed with tax-exempt bonds) is amended to read as follows:

"(C) EXCEPTION FOR PROJECTS FOR RESIDENTIAL RENTAL PROPERTY.—Subparagraph (A) shall not apply to any recovery property which is placed in service in connection with projects for residential rental property financed by the proceeds of obligations described in section 103(b)(4)(A)."

(2) CONFORMING AMENDMENT.—Paragraph (12) of section 168(f) is amended by striking out subpara-

graph (D) and by redesignating subparagraph (E) as subparagraph (D).

(c) AGGREGATION OF ISSUES FOR SINGLE PROJECT.—Paragraph (6) of section 103(b) (relating to exemption for small issues) is amended by adding at the end thereof the following new subparagraph:

> "(P) AGGREGATION OF ISSUES WITH RESPECT TO SINGLE PROJECT.—For purposes of this paragraph, 2 or more issues part or all of which are to be used with respect to a single building, an enclosed shopping mall, or a strip of offices, stores, or residences using substantial common facilities shall be treated as 1 issue (and any person who is a principal user with respect to any of such issues shall be treated as a principal user with respect to the aggregated issue)."

(d) DEFINITION OF RELATED PERSONS IN THE CASE OF PARTNERSHIPS.—Paragraph (13) of section 103(b) (relating to exception where bond held by substantial user) is amended by adding at the end thereof the following new sentence: "For purposes of this paragraph, a partnership and each of its partners (and their spouses and minor children) shall be treated as related persons."

(e) MORTGAGE SUBSIDY BOND ARBITRAGE RULES EXTENDED TO INDUSTRIAL DEVELOPMENT BONDS AND

STUDENT LOAN BONDS.—Subsection (c) of section 103 (relating to arbitrage bonds) is amended by redesignating paragraph (6) as paragraph (7) and by inserting after paragraph (5) the following new paragraph:

"(6) EXTENSION OF MORTGAGE SUBSIDY BOND ARBITRAGE RULES TO PRIVATE ACTIVITY BONDS.—

"(A) IN GENERAL.—Under regulations, any obligation to which this paragraph applies shall be treated as an obligation not described in subsection (a) (1) or (2) unless the issue of which such obligation is a part meets requirements similar to those of section 103A(i).

"(B) OBLIGATIONS TO WHICH PARAGRAPH APPLIES.—

"(i) IN GENERAL.—Except as provided in clause (ii), this paragraph shall apply to any obligation which—

"(I) is an industrial development bond, or

"(II) is a student loan bond (as defined in subsection (n)(8)) issued after December 31, 1985.

"(ii) EXCEPTION FOR MULTIFAMILY HOUSING.—This paragraph shall not apply to any obligation described in subsection (b)(4)(A) nor to any public housing program obligation under section 11(b) of the United States Housing Act of 1937.

"(iii) EXCEPTION FOR REFUNDING OF STUDENT LOAN BONDS ISSUED BEFORE JANUARY 1, 1986.—This paragraph shall not apply to any obligation which is issued to refund a student loan bond issued before January 1, 1986, but only to the extent the requirements of subsection (n)(7)(C) are met with respect to the refunding.

"(C) STUDENT LOAN INCENTIVE PAYMENTS NOT TAKEN INTO ACCOUNT.—For purposes of applying section 103A(i) as made applicable to student loan bonds by subparagraph (A), payments described in paragraph (5) shall not be taken into account."

(f) RESIDENTIAL RENTAL PROPERTY MAY BE IN MIXED USE STRUCTURE.—Paragraph (4) of section 103(b) (relating to certain exempt activities) is amended by adding at the end thereof the following new sentence: "For purposes of subparagraph (A), any property shall not be treated as failing to be residential rental property merely because part of the building in which such property is located is used for purposes other than residential rental purposes."

(g) INCREASE IN AMOUNT OF CAPITAL EXPENDITURES NOT TAKEN INTO ACCOUNT WHERE THERE IS URBAN DEVELOPMENT ACTION GRANT.—Subparagraph (I) of section 103(b)(6) (relating to aggregate amount of capital expenditures where there is urban development action grant) is amended—

(1) by striking out "$10,000,000" and inserting in lieu thereof "$15,000,000", and

(2) by adding at the end thereof the following new sentence: "This subparagraph shall not apply unless the amount of the urban development action grant equals or exceeds 5 percent of a reasonable estimate (made at the time that the Department of Housing and Urban Development gives preliminary approval of the grant) of the total capital expenditures on the facilities with respect to which the action grant has been made."

(h) PUBLIC APPROVAL REQUIREMENT IN THE CASE OF PUBLIC AIRPORT.—If—

(1) the proceeds of any issue are to be used to finance a facility or facilities located on a public airport, and

(2) the governmental unit issuing such obligations is the owner or operator of such airport,

such governmental unit shall be deemed to be the only governmental unit having jurisdiction over such airport for purposes of subsection (k) of section 103 of the Internal Revenue Code of 1954 (relating to public approval for industrial development bonds).

(i) REPEAL OF ADVANCE REFUNDING OF QUALIFIED PUBLIC FACILITIES.—Paragraph (7) of section 103(b) (relating to advance refunding of qualified public facilities) is hereby repealed.

SEC. 726. EFFECTIVE DATES.

(a) PRIVATE ACTIVITY BOND CAP.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendment made by section 721 shall apply to obligations issued after December 31, 1983.

(2) CERTAIN PROJECTS PRELIMINARILY APPROVED BEFORE OCTOBER 19, 1983 GIVEN APPROVAL.—If—

(A) there was an inducement resolution (or other comparable preliminary approval) for a project before October 19, 1983, by any issuing authority, and

(B) a substantial user of such project notifies the issuing authority within 30 days after the date of the enactment of this Act that it intends to claim its rights under this paragraph,

such issuing authority shall allocate its share of the limitation under section 103(n) of such Code for the calendar year during which the obligations were to be issued pursuant to such resolution (or other approval) first to such project. If the amount of obligations required by all projects which meet the requirements of the preceding sentence exceeds the issuing authority's share of the limitation under section 103(n) of such Code, priority under the preceding sentence shall be provided first to those projects for which substantial expenditures were incurred before October 19, 1983. If any issuing authority fails to meet the requirements of this paragraph, the limitation under section 103(n) of such Code for the issuing authority for the calendar year following such failure shall be reduced by the amount of obligations with respect to which such failure occurred.

(3) EXCEPTION FOR CERTAIN BONDS FOR A CONVENTION CENTER AND RESOURCE RECOVERY PROJECT.—In the case of any city, if—

(A) the city council of such city authorized a feasibility study for a convention center on June 10, 1982, and

(B) on October 4, 1983, a municipal authority acting as the management agent for such city selected a proposal for the construction of a facility that will generate steam and electricity through the combustion of municipal waste,

the amendment made by subsection (a) shall not apply to any issue issued during 1984 to finance the convention center described in subparagraph (A) or the facility described in subparagraph (B).

(b) PROPERTY FINANCED WITH TAX-EXEMPT BONDS REQUIRED TO BE DEPRECIATED ON STRAIGHT-LINE BASIS.—

(1) IN GENERAL.—Except as otherwise provided in this section, the amendments made by section 725(b) shall apply to property placed in service after December 31, 1983, to the extent such property is financed by the proceeds of an obligation (including a refunding obligation) issued after October 18, 1983.

(2) EXCEPTIONS.—

(A) CONSTRUCTION OR BINDING AGREEMENT.—The amendments made by section 725(b) shall not apply with respect to facilities—

(i) the original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, or

(ii) with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983.

(B) Refunding.—

(i) In general.—Except as provided in clause (ii), in the case of property placed in service after December 31, 1983, which is financed by the proceeds of an obligation which is issued solely to refund another obligation which was issued before October 19, 1983, the amendments made by section 725(b) shall apply only with respect to an amount equal to the basis in such property which has not been recovered before the date such refunded obligation is issued.

(ii) Significant expenditures.—In the case of facilities the original use of which commences with the taxpayer and with respect to which significant expenditures are made before January 1, 1984, the amendments made by section 725(b) shall not apply with respect to such facilities to the extent such facilities are financed by the proceeds of an obligation issued solely to refund another obligation which was issued before October 19, 1983.

(C) FACILITIES.—In the case of an inducement resolution or other comparable preliminary approval adopted by an issuing authority before October 19, 1983, for purposes of applying subparagraphs (A)(i) and (B)(ii) with respect to obligations described in such resolution, the term "facilities" means the facilities described in such resolution.

(c) OTHER PROVISIONS RELATING TO TAX-EXEMPT BONDS.—

(1) IN GENERAL.—Except as otherwise provided in this section, the amendments made by this subtitle shall apply to obligations issued after December 31, 1983.

(2) OBLIGATIONS INVESTED IN FEDERALLY INSURED DEPOSITS.—Clause (ii) of section 103(h)(2)(B) of the Internal Revenue Code of 1954 (as amended by this subtitle) shall apply to obligations issued after April 14, 1983.

(3) EXCEPTIONS.—

(A) CONSTRUCTION OR BINDING AGREEMENT.—The amendments made by this subtitle (other than section 721) shall not apply to obligations with respect to facilities—

(i) the original use of which commences with the taxpayer and the construction, reconstruction, or rehabilitation of which began before October 19, 1983, or

(ii) with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983.

(B) FACILITIES.—Subparagraph (C) of subsection (b)(2)(A) shall apply for purposes of subparagraph (A) of this paragraph.

(4) REPEAL OF ADVANCE REFUNDING OF QUALIFIED PUBLIC FACILITIES.—The amendment made by section 725(i) shall apply to refunding obligations issued after the date of the enactment of this Act.

(d) PROVISIONS OF THIS SUBTITLE NOT TO APPLY TO CERTAIN PROPERTY.—The amendments made by this subtitle shall not apply to any property (and shall not apply to obligations issued to finance such property) if such property is described in any of the following paragraphs:

(1) Any property described in paragraph (5), (6), or (7) of section 32(g) of this Act.

(2) Any property described in paragraph (3) of section 216(b) of the Tax Equity and Fiscal Responsibility Act of 1982.

(3) Any solid waste disposal facility described in section 103(b)(4)(E) of the Internal Revenue Code of 1954 if—

(A) a State public authority created pursuant to State legislation which took effect on June 18, 1973, took formal action before October 19, 1983, to commit development funds for such facility,

(B) such authority issues obligations for any such facility before January 1, 1987, and

(C) expenditures have been made for the development of any such facility before October 19, 1983.

(e) DETERMINATION OF SIGNIFICANT EXPENDITURE.—

(1) IN GENERAL.—For purposes of this section, the term "significant expenditures" means expenditures which equal or exceed the lesser of—

(A) $15,000,000, or

(B) 20 percent of the estimated cost of the facilities.

(2) CERTAIN GRANTS TREATED AS EXPENDITURES.—For purposes of paragraph (1), the amount of any UDAG grant preliminarily approved on May 5, 1981, or April 4, 1983, shall be treated as an expenditure with respect to the facility for which such grant was so approved.

Subtitle C—Obligations of Certain Educational Organizations

SEC. 731. TAX-EXEMPT STATUS OF OBLIGATIONS OF CERTAIN EDUCATIONAL ORGANIZATIONS.

(a) IN GENERAL.—For purposes of section 103 of the Internal Revenue Code of 1954, a qualified educational organization shall be treated as a State governmental unit, but only with respect to a trade or business carried on by such organization which is not an unrelated trade or business (determined by applying section 513(a) of such Code to such organization).

(b) QUALIFIED EDUCATIONAL ORGANIZATION.—For purposes of subsection (a), the term "qualified educational organization" means a college or university created on February 22, 1855, by specific act of the legislature of the State within which such college or university is located.

(c) EFFECTIVE DATE.—This section shall apply to obligations issued after December 31, 1953.

TITLE VIII—MISCELLANEOUS REVENUE MATTERS

SEC. 800. TABLE OF CONTENTS.

Sec. 800. Table of contents.
Sec. 801. Capital gain treatment for portion of gain on sale of condominium units converted from existing structures.
Sec. 802. No gain recognized from net gifts made before March 4, 1981.
Sec. 803. Disaster loss deduction where taxpayer ordered to demolish or relocate residence in disaster area because of disaster.
Sec. 804. Application of cash or deferred arrangement rules to pre-ERISA money purchase plan.
Sec. 805. Delay of amendments to section 382.
Sec. 806. Extension of Payment-in-Kind Tax Treatment Act of 1983 to wheat for 1984 crop year.
Sec. 807. Taxation of unemployment compensation not to apply to compensation paid for weeks of unemployment ending before December 1, 1978.
Sec. 808. Treatment of transportation expenses incurred with respect to employment at the antiballistic missile site near Nekoma, North Dakota.
Sec. 809. Treatment of home won in local radio contest and specically designed for handicapped foster child.
Sec. 810. Tax treatment of regulated investment companies.
Sec. 811. Tips treated as wages for purposes of Federal unemployment tax.
Sec. 812. Deferral of estate taxes for an interest in a holding company that in turn own stock in a closely held operating company.
Sec. 813. Actuarial adjustments under section 415 for commercial airline pilots made on basis of age 60.
Sec. 814. Cooking wine may be fortified using distilled spirits.
Sec. 815. Transitional rule for treatment of certain income from S corporations as investment income.
Sec. 816. Certain organizations providing child care included within the definition of tax-exempt organizations.

SEC. 801. CAPITAL GAIN TREATMENT FOR PORTION OF GAIN ON SALE OF CONDOMINIUM UNITS CONVERTED FROM EXISTING STRUCTURES.

(a) GENERAL RULE.—Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding at the end thereof the following new section:

“SEC. 1257. CAPITAL GAIN TREATMENT FOR PORTION OF GAIN ON SALE OF CONDOMINIUM UNITS CONVERTED FROM EXISTING STRUCTURES.

“(a) GENERAL RULE.—For purposes of this title, any gain recognized by the taxpayer on the sale or exchange of any qualified condominium unit shall be treated as gain from the sale of property used in the trade or business (as defined in section 1231(b)) to the extent that the gain so recognized does not exceed such unit’s allocable capital gain amount.

“(b) QUALIFIED CONDOMINIUM UNIT.—For purposes of this section—

“(1) IN GENERAL.—The term ‘qualified condominium unit’ means any condominium unit resulting from the conversion of qualified real property into condominium units.

“(2) QUALIFIED REAL PROPERTY.—The term ‘qualified real property’ means any real property—

“(A) which consists of one or more structures (and the land necessary for the use of the structures) used in a trade or business of the taxpayer at all times during the 5-year period ending on the determination date, and

“(B) with respect to which the taxpayer makes an election under this section.

“(3) SPECIAL RULE WHERE PROPERTY ACQUIRED BY INHERITANCE OR DEVISE, ETC.—For purposes of this subsection, the taxpayer shall be treated as holding any property and as using such property in his trade or business during any period during which such property was held and so used—

"(A) in the case of property acquired by inheritance or devise, by the decedent, or

"(B) by any other person if the basis of such property in the hands of the taxpayer is determined (in whole or in part) by reference to the basis of such property in the hands of such other person.

"(c) ALLOCABLE CAPITAL GAIN AMOUNT.—For purposes of this section—

"(1) IN GENERAL.—The term 'allocable capital gain amount' means, with respect to any qualified condominium unit, the portion of the imputed capital gain determined under paragraph (2) with respect to the qualified real property which is allocated to such unit under paragraph (3).

"(2) IMPUTED CAPITAL GAIN.—The term 'imputed capital gain' means, with respect to any qualified real property, the amount of the gain (if any) which—

"(A) would have resulted had such property been sold on the determination date for an amount equal to its fair market value on such date, and

"(B) would have not been treated as ordinary income under section 1245 or 1250.

"(3) ALLOCATION AMONG UNITS.—The amount of the imputed capital gain shall be allocated among condominium units in proportion to their respective fair market values on the determination date.

"(4) FAIR MARKET VALUE DETERMINATIONS.—For purposes of paragraphs (2) and (3), the fair market value (and adjusted basis) of any qualified real property (and of any condominium unit) shall be determined without regard to any improvement made in anticipation of the conversion into condominium units.

"(5) DETERMINATION DATE.—The term 'determination date' means, with respect to any qualified real property, the earliest of—

"(A) the day on which the taxpayer adopted a plan to convert such property into condominium units,

"(B) the day on which substantial improvements were first made to such property in anticipation of a conversion into condominium units, or

"(C) the day on which the form of ownership of such property is changed into condominium units.

If more than 2 years elapses between the sale of the first unit and the second unit, the day taken into account under subparagraphs (A) and (C) shall be the date the second sale is made.

"(d) SPECIAL RULES.—

"(1) ELECTION.—An election under subsection (a) shall be made at such time and in such manner as the Secretary shall by regulations prescribe. Such an election, once made, may be revoked only with the consent of the Secretary.

"(2) SPECIAL RULE FOR CARRYOVER BASIS TRANSACTIONS.—If any taxpayer makes an election under this section with respect to any qualified real property, the same tax treatment which would apply to the taxpayer shall also apply to any other person whose basis in such property is determined (in whole or in part) by reference to the basis of such property in the hands of the taxpayer.

"(3) SPECIAL RULE WHERE SUBSTANTIAL VALUATION OVERSTATEMENT.—

"(A) IN GENERAL.—If the percentage determined by dividing—

"(i) the amount claimed for purposes of subsection (c) as the value of any qualified real property on the determination date, by "(ii) the amount determined to be the correct value of such property on such date for purposes of subsection (c),

exceeds 115 percent, for purposes of this section, the amount of the imputed capital gain shall be reduced by the amount determined under subparagraph (B).

"(B) AMOUNT OF REDUCTION.—The amount of the reduction determined under this subparagraph is an amount equal to—

"(i) 20 percent of the amount which (but for this paragraph) would be the imputed capital gain,

"(ii) for each full percentage point by which the percentage determined under subparagraph (A) exceeds 115 percent."

(b) CLERICAL AMENDMENT.—The table of sections for part IV of subchapter P of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 1257. Capital gain treatment for portion of gain on sale of condominium units converted from existing structures."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to property the form of ownership of which is changed into condominium units after the date of the enactment of this Act in taxable years ending after such date.

SEC. 802. NO GAIN RECOGNIZED FROM NET GIFTS MADE BEFORE MARCH 4, 1981.

(a) IN GENERAL.—In the case of any transfer of property subject to gift tax made before March 4, 1981, for purposes of subtitle A of the Internal Revenue Code of 1954, gross income of the donor shall not include any amount attributable to the donee's payment of (or agreement to pay) any gift tax imposed with respect to such gift.

(b) GIFT TAX DEFINED.—For purposes of subsection (a), the term "gift tax" means—

(1) the tax imposed by chapter 12 of such Code, and

(2) any tax imposed by a State (or the District of Columbia) on transfers by gifts.

(c) STATUTE OF LIMITATIONS.—If refund or credit of any overpayment of tax resulting from subsection (a) is prevented on the date of the enactment of this Act (or at any time within 1 year after such date) by the operation of any law or rule of law (including res judicata), refund or credit of such overpayment (to the extent attributable to subsection (a)) may nevertheless be made or allowed if claim therefor is filed within 1 year after the date of the enactment of this Act.

SEC. 803. DISASTER LOSS DEDUCTION WHERE TAXPAYER ORDERED TO DEMOLISH OR RELOCATE RESIDENCE IN DISASTER AREA BECAUSE OF DISASTER.

(a) GENERAL RULE.—Section 165 (relating to losses) is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

"(k) TREATMENT AS DISASTER LOSS WHERE TAXPAYER ORDERED TO DEMOLISH OR RELOCATE RESIDENCE IN DISASTER AREA BECAUSE OF DISASTER.—In the case of a taxpayer whose residence is located in an area which has been determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1974, if—

"(1) not later than the 120th day after the date of such determination, the taxpayer is ordered, by the government of the State or any political subdivision thereof in which such residence is located, to demolish or relocate such residence, and

"(2) the residence has been rendered unsafe for use as a residence by reason of the disaster,

any loss attributable to such disaster shall be treated as a loss which arises from a casualty and which is described in subsection (i)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years ending after December

31, 1981, with respect to residences in areas determined by the President of the United States, after such date, to warrant assistance by the Federal Government under the Disaster Relief Act of 1974.

SEC. 804. APPLICATION OF CASH OR DEFERRED ARRANGEMENT RULES TO PRE-ERISA MONEY PURCHASE PLAN.

(a) GENERAL RULE.—Paragraphs (1) and (2) of section 401(k) (relating to cash or deferred arrangements) are each amended by inserting "(or a pre-ERISA money purchase plan)" after "stock bonus plan".

(b) DEFINITION OF PRE-ERISA MONEY PURCHASE PLAN.—Subsection (k) of section 401 is amended by adding at the end thereof the following new paragraph:

"(5) PRE-ERISA MONEY PURCHASE PLAN.—For purposes of this subsection, the term 'pre-ERISA money purchase plan' means a pension plan—

"(A) which is a defined contribution plan (as defined in section 414(i)),

"(B) which was in existence on June 27, 1974, and which, on such date, included a salary reduction arrangement, and

"(C) under which neither the employee contributions nor the employer contributions may exceed the levels provided for by the contribution formula in effect under the plan on such date."

(c) TECHNICAL AMENDMENT.—Subparagraph (B) of section 401(k)(2) as amended by striking out ", hardship or the attainment of age 59½," and inserting in lieu thereof "(or in the case of a profit sharing or stock bonus plan, hardship or the attainment of age 59½)".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply with respect to plan years beginning after the date of the enactment of this Act.

(2) TRANSITIONAL RULE.—Rules similar to the rules under section 135(c)(2) of the Revenue Act of 1978 shall apply with respect to any pre-ERISA money purchase plan (as defined in section 401(k)(5) of the Internal Revenue Code of 1954) for plan years beginning after December 31, 1979, and on or before the date of the enactment of this Act.

SEC. 805. DELAY OF AMENDMENTS TO SECTION 382.

Subsection (g) of section 806 of the Tax Reform Act of 1976 is amended—

(1) by striking out "January 1, 1984" in paragraphs (2) and (3) and inserting in lieu thereof "November 1, 1984", and

(2) by striking out "June 30, 1984" in paragraph (2) and inserting in lieu thereof "October 31, 1984".

SEC. 806. EXTENSION OF PAYMENT-IN-KIND TAX TREATMENT ACT OF 1983 TO WHEAT FOR 1984 CROP YEAR.

(a) EXTENSION.—

(1) IN GENERAL.—Section 5 of the Payment-in-Kind Tax Treatment Act of 1983 (relating to definitions and special rules) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) EXTENSION TO WHEAT PLANTED AND HARVESTED IN 1984.—In the case of wheat—

"(1) any reference in this Act to the 1983 crop year shall include a reference to the 1984 crop year, and

"(2) any reference to the 1983 payment-in-kind program shall include a reference to any program for the 1984 year for wheat which meets the requirements of subparagraphs (A) and (B) of subsection (a)(1)."

(2) DEFINITION OF CROP YEAR.—Paragraph (2) of section 5(a) of such Act is amended to read as follows:

"(2) CROP YEAR.—The term '1983 crop year' means the crop year for any crop the planting or harvesting period for which occurs during 1983. The term

'1984 crop year' means the crop year for wheat the planting and harvesting period for which occurs during 1984."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply with respect to commodities received for the 1984 crop year (as defined in section 5(a)(2) of the Payment-in-Kind Tax Treatment Act of 1983 as amended by subsection (a)).

(2) INCOME TAX TREATMENT NOT TO APPLY FOR 1984 CROP YEAR TO THE EXTENT PAYMENTS DETERMINED TO BE ILLEGAL.—

(A) IN GENERAL.—If it is determined in a judicial proceeding brought under subparagraph (B) that the $50,000 limitation of section 1101(1) of the Agriculture and Food Act of 1981 applies to payments-in-kind under the Payment-in-Kind (PIK) programs, section 2(a) of the Payment-in-Kind Tax Treatment Act of 1983 shall apply to commodities received for the 1984 crop year only to the extent that the receipt of such commodities is legal under such determination.

(B) COMPTROLLER GENERAL TO BRING ACTION FOR DECLARATORY JUDGMENT.—

(i) IN GENERAL.—Not later than 60 days after the date of the enactment of this Act, the Comptroller General of the United States shall (and notwithstanding any other provision of law is hereby authorized to) bring an action in the name of the United States against the Secretary of Agriculture in the United States District Court for the District of Columbia for a declaration with respect to the issue of whether the $50,000 limitation of section 1101(1) of the Agriculture and Food Act of 1981 applies to payments-in-kind under the Payment-in-Kind (PIK) programs.

(ii) PRIORITY.—To the maximum extent possible, the United States District Court for the District of Columbia shall give priority to the action brought under this subparagraph.

(C) DECLARATION ONLY TO APPLY FOR INCOME TAX TREATMENT FOR 1984 CROP YEAR.—Nothing in any declaration in a proceeding brought under subparagraph (B) shall affect—

(i) the tax treatment under the Payment-in-Kind Tax Treatment Act of 1983 for the 1983 crop year,

(ii) the tax treatment under such Act for the 1984 crop year other than the tax treatment under section 2(a) of such Act, or

(iii) the tax treatment of a cooperative with respect to commodities received on behalf of another person.

SEC. 807. TAXATION OF UNEMPLOYMENT COMPENSATION NOT TO APPLY TO COMPENSATION PAID FOR WEEKS OF UNEMPLOYMENT ENDING BEFORE DECEMBER 1, 1978.

(a) GENERAL RULE.—Subsection (d) of section 112 of the Revenue Act of 1978 (relating to taxation of unemployment compensation benefits at certain income levels) is amended to read as follows:

"(d) EFFECTIVE DATE.—The amendments made by this section shall apply to payments of unemployment compensation made after December 31, 1978, in taxable years ending after such date; except that such amendments shall not apply to payments made for weeks of unemployment ending before December 1, 1978."

(b) WAIVER OF STATUTE OF LIMITATIONS.—If credit or refund of any overpayment of tax resulting from the amendment made by subsection (a) is barred on the date of the enactment of this Act or at any time during the 1-year period beginning on the date of the enactment of this Act by the operation of any law or rule of law (including res judicata), refund or credit of such overpayment (to the extent attributable to the amendment made by subsection (a)) may, nevertheless, be made or allowed if claim thereor is filed before the close of such 1-year period.

SEC. 808. TREATMENT OF TRANSPORTATION EXPENSES INCURRED WITH RESPECT TO EMPLOYMENT AT THE ANTIBALLISTIC MISSILE SITE NEAR NEKOMA, NORTH DAKOTA.

(a) General Rule.—Employment at the antiballistic missile project near Nekoma, North Dakota, shall be treated for purposes of sections 62 and 162 of the Internal Revenue Code of 1954 as temporary employment with respect to transportation and traveling expenses—

(1) otherwise allowable as a deduction under section 162(a) of such Code,

(2) paid or incurred after 1969 and before 1975, and

(3) claimed on a return filed for any taxable year which includes any portion of the period described in paragraph (2).

(b) Waiver of Statute of Limitations.—If refund or credit of any overpayment of Federal income tax resulting from the application of subsection (a) is prevented at any time before the date one year after the date of the enactment of this Act by the operation of any law or rule of law (including res judicata), refund or credit of such overpayment (to the extent attributable to the application of subsection (a)) may, nevertheless, be made or allowed if claim therefor is filed before the date one year after the date of the enactment of this Act.

(c) Effective Date.—This section shall apply to taxable years ending after December 31, 1969.

SEC. 809. TREATMENT OF HOME WON IN LOCAL RADIO CONTEST AND SPECIALLY DESIGNED FOR HANDICAPPED FOSTER CHILD.

(a) If the Federal income tax attributable to the receipt of the prize described in subsection (b) is paid within one year after the date of the enactment of this Act, such payment shall be treated for purposes of the Internal Revenue Code of 1954 as being in full satisfaction of such tax and all interest, additions to the tax, additional amounts, and penalties in respect of liability for such Federal income tax.

(b) For purposes of subsection (a), the prize described in this subsection is a residence which—

(1) was won by the taxpayer in a local radio contest,

(2) was specially designed to meet the needs of a handicapped foster child of the taxpayer,

(3) is the principal residence (within the meaning of section 1034 of such Code) of the taxpayer, and

(4) had a lien placed on it by the Internal Revenue Service on May 24, 1983, after an Internal Revenue Service supervisor had overruled two payment schedules negotiated with the taxpayer for the payment of taxes, interest, and penalties on income attributable to such residence for the taxpayer's 1980 taxable year.

(c) For purposes of subsection (a), the Federal income tax attributable to the prize described in subsection (b) shall be determined without regard to interest, additions to the tax, additional amounts, and penalties.

SEC. 810. TAX TREATMENT OF REGULATED INVESTMENT COMPANIES.

(a) PERSONAL HOLDING COMPANIES PERMITTED TO BE REGULATED INVESTMENT COMPANIES.—

(1) IN GENERAL.—Subsection (a) of section 851 (defining regulated investment company) is amended by striking out "(other than a personal holding company as defined in section 542)".

(2) SPECIAL RULE FOR RATE OF TAX.—Paragraph (1) of section 852(b) (relating to imposition of tax on regulated investment companies) is amended by adding at the end thereof the following new sentence: "In the case of a regulated investment company which is a personal holding company (as defined in section 542), that tax shall be computed at the highest rate of tax specified in section 11(b)."

(3) REQUIREMENT THAT INVESTMENT COMPANY HAVE NO EARNINGS AND PROFITS ACCUMULATED IN YEAR FOR WHICH IT WAS NOT A REGULATED INVESTMENT COMPANY.—Subsection (a) of section 852 (relating to requirements applicable to regulated investment companies) is amended by striking out "and" at the end of paragraph (1), by striking out the period at the end of paragraph (2) and inserting in lieu thereof ", and", and by adding at the end thereof the following new paragraph:

"(3) either—

"(A) the provisions of this part applied to the investment company for all taxable years ending on or after November 8, 1983, or

"(B) as of the close of the taxable year, the investment company has no earnings and profits accumulated in any taxable year to which the provisions of this part (or the corresponding provisions of prior law) did not apply to it."

(4) PROCEDURES SIMILAR TO DEFICIENCY DIVIDEND PROCEDURES MADE APPLICABLE.—Section 852 is amended by adding at the end thereof the following new subsection:

"(e) PROCEDURES SIMILAR TO DEFICIENCY DIVIDEND PROCEDURES MADE APPLICABLE.—

"(1) IN GENERAL.—If—

"(A) there is a determination that the provisions of this part do not apply to an investment company for any taxable year (hereinafter in this subsection referred to as the 'non-RIC year'), and

"(B) such investment company meets the distribution requirements of paragraph (2) with respect to the non-RIC year,

for purposes of applying subsection (a)(3) to subsequent taxable years, the provisions of this part shall be treated as applying to such investment company for the non-RIC year.

"(2) DISTRIBUTION REQUIREMENTS.—

"(A) IN GENERAL.—The distribution requirements of this paragraph are met with respect to any non-RIC year if, within the 90-day period beginning on the date of the determination (or within such longer period as the Secretary may permit), the investment company makes 1 or more qualified designated distributions and the amount of such distributions is not less than the excess of—

"(i) the portion of the accumulated earnings and profits of the investment company (as of the date of the determination) which are attributable to the non-RIC year, over

"(ii) any interest payable under paragraph (3).

"(B) QUALIFIED DESIGNATED DISTRIBUTION.—For purposes of this paragraph, the term 'qualified designated distribution' means any distribution made by the investment company if—

"(i) section 301 applies to such distribution, and

"(ii) such distribution is designated (at such time and in such manner as the Secretary shall by regulations prescribe) as being taken into account under this paragraph with respect to the non-RIC year.

"(C) EFFECT ON DIVIDENDS PAID DEDUCTION.—Any qualified designated distribution shall not be included in the amount of dividends paid for purposes of computing the dividends paid deduction for any taxable year.

"(3) INTEREST CHARGE.—

"(A) IN GENERAL.—If paragraph (1) applies to any non-RIC year of an investment company, such investment company shall pay interest at the annual rate established under section 6621—

"(i) on an amount equal to 50 percent of the amount referred to in paragraph (2)(A)(i),

"(ii) for the period—

"(I) which begins on the last day prescribed for payment of the tax imposed for the non-RIC year (determined without regard to extensions), and

"(II) which ends on the date the determination is made.

"(B) COORDINATION WITH SUBTITLE F.—Any interest payable under subparagraph (A) may be assessed and collected at any time during the period during which any tax imposed for the taxable year in which the determination is made may be assessed and collected.

"(4) PROVISION NOT TO APPLY IN THE CASE OF FRAUD.—The provisions of this subsection shall not apply if the determination contains a finding that the failure to meet any requirement of this part was due to fraud with intent to evade tax.

"(5) DETERMINATION.—For purposes of this subsection, the term 'determination' has the meaning given to such term by section 860(e). Such term also includes a determination by the investment company filed with the Secretary that the provisions of this part do not apply to the investment company for a taxable year."

(5) EFFECTIVE DATES.—

(A) IN GENERAL.—Except as otherwise provided in this paragraph, the amendments made by this subsection shall apply to taxable years beginning after December 31, 1982.

(B) INVESTMENT COMPANIES WHICH WERE REGULATED INVESTMENT COMPANIES FOR YEARS ENDING BEFORE NOVEMBER 8, 1983.—In the case of any investment company to which the provisions of part I of subchapter M of chapter 1 of the Internal Revenue Code of 1954 applied for any taxable year ending before November 8, 1983, for purposes of section 852(a)(3)(B) of the

Internal Revenue Code of 1954 (as amended by this subsection), no earnings and profits accumulated in any taxable year ending before January 1, 1984, shall be taken into account.

(C) INVESTMENT COMPANIES BEGINNING BUSINESS IN 1983.—In the case of an investment company which began business in 1983 (and was not a successor corporation), earnings and profits accumulated during its first taxable year shall not be taken into account for purposes of section 852(a)(3)(B) of such Code (as so amended).

(b) SHORT-TERM OBLIGATIONS ISSUED ON A DISCOUNT BASIS.—

(1) IN GENERAL.—Paragraph (2) of section 852(b) (defining investment company taxable income) is amended by adding at the end thereof the following new subparagraph—

"(F) The taxable income shall be computed without regard to section 454(b) (relating to short-term obligations issued on a discount basis) if the company so elects in a manner prescribed by the Secretary."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to taxable years beginning after December 31, 1978.

SEC. 811. TIPS TREATED AS WAGES FOR PURPOSES OF FEDERAL UNEMPLOYMENT TAX.

(a) GENERAL RULE.—Section 3306 (relating to definitions for purposes of Federal unemployment tax) is amended by adding at the end thereof the following new subsection:

"(s) TIPS TREATED AS WAGES.—For purposes of this chapter, the term 'wages' includes tips which are—

"(1) received while performing services which constitute employment, and

"(2) included in a written statement furnished to the employer pursuant to section 6053(a)."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendment made by subsection (a) shall take effect on January 1, 1985.

(2) EXCEPTION FOR CERTAIN STATES.—In the case of any State the legislature of which—

(A) did not meet in a regular session which begins during 1984 and after the date of the enactment of this Act, and

(B) did not meet in a session which began before the date of the enactment of this Act and remained in session for at least 25 calendar days after such date of enactment,

the amendment made by subsection (a) shall take effect on January 1, 1986.

SEC. 812. DEFERRAL OF ESTATE TAXES FOR AN INTEREST IN A HOLDING COMPANY THAT IN TURN OWNS STOCK IN A CLOSELY HELD OPERATING COMPANY.

(a) In General.—Subsection (b) of section 6166 (providing definitions and special rules for extension of time for payment of estate tax where estate consists largely of interest in closely held business) is amended by adding after paragraph (7) the following new paragraph:

"(8) Interest in closely held business owned through holding company—

"(A) In general.—If the executor elects the benefits of this paragraph (at such time and in such manner as the Secretary shall by regulation prescribe) and if 80 percent or more in value of the assets of one corporation consists of nonreadily tradeable stock (as defined in paragraph (7)(B)) in a second corporation carrying on a trade or business, then—

"(i) for purposes of this section (other than paragraph (1)(C)(i)), a proportionate part of the stock of the first corporation which is included in determining the gross estate of the decedent shall be treated as stock of the second corporation, "(ii) for purposes of paragraph (1)(C)(i), a portion of the voting stock of the second corporation which is held by the first corporation shall be treated as included in determining the gross estate of the decedent,

"(iii) the executor shall be treated as having selected under subsection (a)(3) the date prescribed by section 6151(a), and

"(iv) section 6601(j) (relating to 4-percent rate of interest) shall not apply.

"(B) 20-PERCENT REQUIREMENT.—The portion referred to in subparagraph (A)(ii) shall be determined according to the proportion of the value of the voting stock of the first corporation which is included in determining the gross estate of the decedent.

"(C) OTHER ASSETS EXCLUDED.—The proportionate part referred to in subparagraph (A)(i) shall be determined according to the ratio which the value of the stock of the second corporation which is held by the first corporation bears to the value of all assets of the first corporation."

(b) ACCELERATION OF PAYMENT.—Paragraph (1) of section 6166(g) (relating to disposition of interest; withdrawal of funds from business) is amended by adding at the end thereof the following new subparagraph:

"(E) If any portion of stock in a corporation (described as the first corporation in subsection (b)(8)(A)) is treated as stock in a second corporation by reason of subsection (b)(8)(A)—

"(i)(I) any disposition of any interest in such stock in such first corporation, which was included in determining the gross estate of the decedent, or

"(II) any withdrawal of any money or other property from such first corporation attributable to any interest included in determining the gross estate of the decedent,

shall be treated for purposes of this paragraph as a disposition of (or a withdrawal with respect to) all such stock qualifying under subsection (a)(1), and

"(ii)(I) any disposition of any interest in such stock in such second corporation by such first corporation, or

"(II) any withdrawal of any money or other property from such second corporation attributable to such stock by such first corporation owning such stock.

shall be treated for purposes of this paragraph as a disposition of (or a withdrawal with respect to) all such stock qualifying under subsection (a)(1)."

(c) Paragraph (2) of section 6166(g) (relating to undistributed income of estate) is amended by adding at the end thereof the following new subparagraph:

"(C) For purposes of this paragraph, dividends paid to a corporation owning nonreadily tradable stock in a corporation carrying on a trade or business (as described in subsection (b)(8)(A)) by such corporation shall be treated as paid to the estate of the decedent."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to estates of decedents dying after the date of the enactment of this Act.

SEC. 813. ACTUARIAL ADJUSTMENTS UNDER SECTION 415 FOR COMMERCIAL AIRLINE PILOTS MADE ON BASIS OF AGE 60.

(a) GENERAL RULE.—Subsection (b) of section 415 (relating to limitation for defined benefit plans) is amended by adding at the end thereof the following new paragraph:

"(8) SPECIAL RULE FOR COMMERCIAL AIRLINE PILOTS.—The case of any participant who is a commercial airline pilot, if—

"(A) the benefit begins at or after age 60, and

"(B) as of the time the benefit begins, regulations prescribed by the Federal Aviation Administration do not permit an individual to serve as a commercial airline pilot after attaining age 60,

paragraph (2)(C) shall be applied by substituting 'age 60' for 'age 62' each place it appears."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect as if it had been included in section 235 of the Tax Equity and Fiscal Responsibility Act of 1982.

SEC. 814. COOKING WINE MAY BE FORTIFIED USING DISTILLED SPIRITS.

(a) IN GENERAL.—Subsection (a) of section 5214 (relating to withdrawal of distilled spirits from bonded premises free of tax or without payment of tax) is amended by striking out the period at the end of paragraph (12) and inserting in lieu thereof "; or", and by adding at the end thereof the following new paragraph:

"(13) without payment of tax for use on bonded wine cellar premises in the production of wine or wine products which will be rendered unfit for beverage use and removed pursuant to section 5362(d)."

(b) LIABILITY FOR TAX.—

(1) Paragraph (1) of section 5005(e) (relating to withdrawals without payment of tax) is amended by striking out "or (10)" and inserting in lieu thereof "(10), or (13)".

(2) Paragraph (2) of section 5005(e) is amended by inserting "used in the production of nonbeverage wine or wine products," after "used in the production of wine,".

(c) TECHNICAL AMENDMENT.—Section 5354 (relating to bonds for bonded wine cellars) is amended by striking out "wine spirits" each place it appears and inserting in lieu thereof "distilled spirits".

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

SEC. 815. TRANSITIONAL RULE FOR TREATMENT OF CERTAIN INCOME FROM S CORPORATIONS AS INVESTMENT INCOME.

(a) IN GENERAL.—If—

(1) a corporation was an S corporation for the taxable years of such corporation beginning in 1982, 1983, and 1984, and

(2) a shareholder of such corporation makes an election to have this section apply,

then any qualified income which such shareholder takes into account by reason of holding stock in such corporation for any taxable year of such corporation beginning in 1983 or 1984 shall be treated as net investment income for purposes of section 163(d) of the Internal Revenue Code of 1954.

(b) DEFINITIONS.—For purposes of subsection (a)—

(1) QUALIFIED INCOME.—The term "qualified income" means any income other than income which is attributable to personal services performed by the shareholder for the S corporation.

(2) S CORPORATION.—The term "S corporation" has the meaning given such term by section 1361(a) of the Internal Revenue Code of 1954.

(c) ELECTION.—The election under subsection (a) shall be made at such time and in such manner as the Secretary of the Treasury or his delegate may by regulations prescribe.

SEC. 816. CERTAIN ORGANIZATIONS PROVIDING CHILD CARE INCLUDED WITHIN THE DEFINITION OF TAX-EXEMPT ORGANIZATIONS.

(a) IN GENERAL.—Section 501 (relating to exemption from tax on corporations, certain trusts, etc.) is amended by redesignating subsection (k) as subsection (l) and inserting after subsection (j) the following new subsection:

"(k) TREATMENT OF CERTAIN ORGANIZATIONS PROVIDING CHILD CARE.—For purposes of subsection (c)(3) of this section and sections 170(c)(2), 2055(a)(2), and 2522(a)(2), the term 'educational purposes' includes the providing of care of children away from their homes if—

"(1) substantially all of the care provided by the organization is for purposes of enabling individuals to be gainfully employed, and

"(2) the services provided by the organization are available to the general public."

(b) CROSS REFERENCES.—

(1) Subsection (k) of section 170 is amended by redesignating paragraphs (1) through (8) as paragraphs (2) through (9), respectively, and by inserting before paragraph (2) (as so redesignated) the following new paragraph:

"(1) For treatment of certain organizations providing child care, see section 501(k)."

(2) Subsection (f) of section 2055 is amended by redesignating paragraphs (2) through (11) as paragraphs (3) through (12), respectively, and by inserting after paragraph (1) the following new paragraph:

"(2) For treatment of certain organizations providing child care, see section 501(k)."

(3) Subsection (d) of section 2522 is amended by redesignating paragraphs (1) and (2) as paragraphs (2) and (3), respectively, and by inserting before paragraph (2) (as so redesignated) the following new paragraph:

"(1) For treatment of certain organizations providing child care, see section 501(k)."

(c) Effective Dates.—The amendments made by subsections (a) and (b) shall apply to taxable years beginning after the date of the enactment of this Act.

TITLE IX—SOCIAL SECURITY DISABILITY BENEFITS REFORM

SEC. 900. SHORT TITLE; TABLE OF CONTENTS.

This title may be cited as the "Social Security Disability Benefits Reform Act of 1983".

TABLE OF CONTENTS

Sec. 900. Short title; table of contents.

Subtitle A—Standards of Disability

Sec. 901. Standard of review for termination of disability benefits and periods of disability
Sec. 902. Study concerning evaluation of pain.
Sec. 903. Multiple impairments.

Subtitle B—Disability Determination Process

Sec. 911. Moratorium on mental impairment reviews.
Sec. 912. Review procedure governing disability determinations affecting continued entitlement to disability benefits; demonstration projects relating to review of other disability determinations.
Sec. 913. Continuation of benefits during appeal.
Sec. 914. Qualifications of medical professionals evaluating mental impairments.
Sec. 915. Regulatory standards for consultative examinations.

Subtitle C—Miscellaneous Provisions

Sec. 921. Administrative procedure and uniform standards.
Sec. 922. Compliance with court of appeals decisions.
Sec. 923. Payment of costs of rehabilitation services.
Sec. 924. Advisory Council on Medical Aspects of Disability.
Sec. 925. Qualifying experience for appointment of certain staff attorneys to administrative law judge positions.
Sec. 926. SSI benefits for individuals who perform substantial gainful activity despite severe medical impairment.
Sec. 927. Additional functions of Advisory Council; work evaluations in case of applicants for and recipients of SSI benefits based on disability.
Sec. 928. Effective date.

Subtitle A—Standards of Disability

SEC. 901. STANDARD OF REVIEW FOR TERMINATION OF DISABILITY BENEFITS AND PERIODS OF DISABILITY.

(a) Section 223 of the Social Security Act is amended by inserting after subsection (e) the following new subsection:

"Standard of Review for Termination of Disability Benefits

"(f) A recipient of benefits under this title or title XVIII based on the disability of any individual may be determined not to be entitled to such benefits on the basis of a finding that the physical or mental impairment on the basis of which such benefits are provided has ceased, does not exist, or is not disabling only if such finding is supported by—

"(1) substantial evidence which demonstrates that there has been medical improvement in the individual's impairment or combination of impairments so that—

"(A) the individual is now able to engage in substantial gainful activity, or

"(B) if the individual is a widow or surviving divorced wife under section 202(e) or a widower or surviving divorced husband under section 202(f), the severity of his or her impairment or impairments is no longer deemed under regulations prescribed by the Secretary sufficient to preclude the individual from engaging in gainful activity; or

"(2) substantial evidence which—

"(A) consists of new medical evidence and (in a case to which clause (ii) does not apply) a new assessment of the individual's residual functional capacity and demonstrates that, although the individual has not improved medically, he or she is nonetheless a beneficiary of advances in medical or vocational therapy or technology so that—

"(i) the individual is now able to engage in substantial gainful activity, or

"(ii) if the individual is a widow or surviving divorced wife under section 202(e) or a widower or surviving divorced husband under section 202(f), the severity of his or her impairment or impairments is no longer deemed under regulations prescribed by the Secretary sufficient to preclude the individual from engaging in gainful activity; or

"(B) demonstrates that, although the individual has not improved medically, he or she has undergone vocational therapy so that the requirements of clause (i) or (ii) of subparagraph (A) are met; or

"(3) substantial evidence which demonstrates that, as determined on the basis of new or improved diagnostic techniques or evaluations, the individual's impairment or combination of impairments is not as disabling as it was considered to be at the time of the most recent prior decision that he or she was under a disability or continued to be under a disability, and that therefore—

"(A) the individual is able to engage in substantial gainful activity, or

"(B) if the individual is a widow or surviving divorced wife under section 202(e) or a widower or surviving divorced husband under section 202(f), the severity of his or her impairment or impairments is not deemed under regulations prescribed by the Secretary sufficient to preclude the individual from engaging in gainful activity.

Nothing in this subsection shall be construed to require a determination that a recipient of benefits under this title or title XVIII based on an individual's disability is entitled to such benefits if evidence on the record at the time any prior determination of such entitlement to disability benefits was made, or new evidence which relates to that determination, shows that the prior determination was either clearly erroneous at the time it was made or was fraudulently obtained, or if the individual is engaged in substantial gainful activity. In any case in which there is no available medical evidence supporting a prior disability determination, nothing in this subsection shall preclude the Secretary, in attempting to meet the requirements of the preceding provisions of this subsection, from securing additional medical reports necessary to reconstruct the evidence which supported such prior disability determination. For purposes of this subsection, a benefit under this title is based on an individual's disability if it is a disability insurance benefit, a child's, widow's, or widower's insurance benefit based on disability, or a mother's or father's insurance benefit based on the disability of the mother's or father's child who has attained age 16.".

(b) Section 216(i)(2)(D) of such Act is amended by adding at the end thereof the following: "A period of disability may be determined to end on the basis of a finding that the physical or mental impairment on the basis of which the finding of disability was made has ceased, does not exist, or is not disabling only if such finding is supported by substantial evidence described in paragraph (1), (2), or (3) of section 223(f). Nothing in the preceding sentence shall be construed to require a determination that a period of disability continues if evidence on the record at the time any prior determination of such period of disability was made, or new evidence which relates to such determination, shows that the prior determination was either clearly erroneous at the time it was made or was fraudulently obtained, or if the individual is engaged in substantial gainful activity. In any case in which there is no available medical evidence supporting a prior disability determination, nothing in this subparagraph shall preclude the Secretary, in attempting to meet the requirements of the preceding provisions of this subparagraph, from securing additional medical reports necessary to reconstruct the evidence which supported such prior disability determination.".

(c) Section 1614(a) of such Act is amended by adding at the end thereof the following new paragraph:

"(5) A recipient of benefits based on disability under this title may be determined not be to entitled to such benefits on the basis of a finding that the physical or mental impairment on the basis of which such benefits are provided has ceased, does not exist, or is not disabling only if such finding is supported by—

"(A) substantial evidence which demonstrates that there has been medical improvement in the individual's impairment or combination of impairments so that the individual is now able to engage in substantial gainful activity; or

"(B) substantial evidence (except in the case of an individual eligible to receive benefits under section 1619) which—

"(i) consists of new medical evidence and a new assessment of the individual's residual functional capacity and demonstrates that, although the individual has not improved medically, he or she is nonetheless a beneficiary of advances in medical or vocational therapy or technology so that the individual is now able to engage in substantial gainful activity, or

"(ii) demonstrates that, although the individual has not improved medically, he or she has undergone vocational therapy so that he or she is now able to engage in substantial gainful activity; or

"(C) substantial evidence which demonstrates that, as determined on the basis of new or improved diagnostic techniques or evaluations, the individual's impairment or combination of impairments is not as disabling as it was considered to be at the time of the most recent prior decision that he or she was under a disability or continued to be under a disability, and that therefore the individual is able to engage in substantial gainful activity.

Nothing in this paragraph shall be construed to require a determination that a recipient of benefits under this title based on disability is entitled to such benefits if evidence on the record at the time any prior determination of such entitlement to benefits was made, or new evidence which relates to that determination, shows that the prior determination was either clearly erroneous at the time it was made or was fraudulently obtained, or if the individual (unless he or she is eligible to receive benefits under section 1619) is engaged in substantial gainful activity. In any case in which there is no available medical evidence supporting a prior determination of disability nothing in this paragraph shall preclude the Secretary, in attempting to meet the requirements of the [illegible]ceding provisions of this paragraph, from securing additional medical reports necessary to reconstruct the evidence which supported such prior determination.".

SEC. 902. STUDY CONCERNING EVALUATION OF PAIN.

(a) The Secretary of Health and Human Services shall, in conjunction with the National Academy of Sciences, conduct a study of the issues concerning (1) the use of subjective evidence of pain, including statements of the individual alleging such pain as to the intensity and persistence of such pain and corroborating evidence provided by treating physicians, family, neighbors, or behavioral indicia, in determining under section 221 or title XVI of the Social Security Act whether an individual is under a disability, and (2) the state of the art of preventing, reducing, or coping with pain.

(b) The Secretary shall submit the results of the study under subsection (a), together with any recommendations, to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate not later than April 1, 1985.

SEC. 903. MULTIPLE IMPAIRMENTS.

(a)(1) Section 223(d)(2) of the Social Security Act is amended by adding at the end thereof the following new subparagraph:

> "(C) In determining whether an individual's physical or mental impairment or impairments are of such severity that he or she is unable to engage in substantial gainful activity, the Secretary shall consider the combined effect of all of the individual's impairments without regard to whether any such impairment, if considered separately, would be of such severity.".

(2) The third sentence of section 216(i)(1) of such Act is amended by inserting "(2)(C)," after "(2)(A),".

(b) Section 1614(a)(3) of such Act is amended by adding at the end thereof the following new subparagraph:

"(G) In determining whether an individual's physicial or mental impairment or impairments are of such severity that he or she is unable to engage in substantial gainful activity, the Secretary shall consider the combined effect of all of the individual's impairments without regard to whether any such impairment, if considered separately, would be of such severity.".

Subtitle B—Disability Determination Process

SEC. 911. MORATORIUM ON MENTAL IMPAIRMENT REVIEWS.

(a) The Secretary of Health and Human Services (hereafter in this section referred to as the "Secretary") shall revise the criteria embodied under the category "Mental Disorders" in the "Listing of Impairments" in effect on the date of the enactment of this Act under appendix 1 to subpart P of part 404 of title 20 of the Code of Federal Regulations. The revised criteria and listings, alone and in combination with assessments of the residual functional capacity of the individuals involved, shall be designed to realistically evaluate the ability of a mentally impaired individual to engage in substantial gainful activity in a competitive workplace environment. Regulations establishing such revised criteria and listings shall be published no later than nine months after the date of the enactment of this Act.

(b) The Secretary shall make the revisions pursuant to subsection (a) in consultation with the Advisory Council on the Medical Aspects of Disability (established by section 924 of this Act), and shall take the advice and recommendations of such Council fully into account in making such revisions.

(c)(1) Until such time as revised criteria have been established by regulation in accordance with subsection (a), no continuing eligibility review shall be carried out under section 221(h) of the Social Security Act (as redesignated by section 914(1) of this Act), or under the corresponding requirements established for disability determinations and reviews under title XVI of such Act, with respect to any individual previously determined to be under a disability by reason of a mental impairment, if—

(A) no initial decision on such review has been rendered with respect to such individual prior to the date of the enactment of this Act, or

(B) an initial decision on such review was rendered with respect to such individual prior to the date of the enactment of this Act but a timely appeal from such decision was filed or was pending on or after June 7, 1983.

For purposes of this paragraph and subsection (d)(1) the term "continuing eligibility review", when used to refer to a review of a previous determination of disability, includes any reconsideration of or hearing on the initial decision rendered in such review as well as such initial decision itself, and any review by the Appeals Council of the hearing decision.

(2) Paragraph (1) shall not apply in any case where the Secretary determines that fraud was involved in the prior determination, or where an individual (other than an individual eligible to receive benefits under section 1619 of the Social Security Act) is determined by the Secretary to be engaged in substantial gainful activity.

(d)(1) Any initial determination that an individual is not under a disability by reason of a mental impairment and any determination that an individual is not under a disability by reason of a mental impairment in a reconsideration of or hearing on an initial disability determination, made or held under title II or XVI of the Social Security Act after the date of the enactment of this Act and prior to the date on which revised criteria are established by regulation in accordance with subsection (a), and any determination that an individual is not under a disability by reason of a mental impairment made under or in accordance with title II or XVI of such Act in a reconsideration of, hearing on, or judicial review of a decision rendered in any continuing eligibility review to which subsection (c)(1) applies, shall be redetermined by the Secretary as soon as feasible after the date on which such criteria are so established, applying such revised criteria.

(2) In the case of a redetermination under paragraph (1) of a prior action which found that an individual was not

under a disability, if such individual is found on redetermination to be under a disability, such redetermination shall be applied as though it had been made at the time of such prior action.

(3) Any individual with a mental impairment who was found to be not disabled pursuant to an initial disability determination or a continuing eligibility review between March 1, 1981, and the date of the enactment of this Act, and who reapplies for benefits under title II or XVI of the Social Security Act, may be determined to be under a disability during the period considered in the most recent prior determination. Any reapplication under this paragraph must be filed within one year after the date of the enactment of this Act, and benefits payable as a result of the preceding sentence shall be paid only on the basis of the reapplication.

SEC. 912. REVIEW PROCEDURE GOVERNING DISABILITY DETERMINATIONS AFFECTING CONTINUED ENTITLEMENT TO DISABILITY BENEFITS; DEMONSTRATION PROJECTS RELATING TO REVIEW OF OTHER DISABILITY DETERMINATIONS.

(a)(1) Section 221(d) of the Social Security Act is amended—

(A) by striking out "Any" and inserting in lieu thereof "(1) Except in cases to which paragraph (2) applies, any"; and

(B) by adding at the end thereof the following new paragraph:

"(2)(A) In any case where—

"(i) an individual is a recipient of disability insurance benefits, child's, widow's, or widower's insurance benefits based on disability, mother's or father's insurance benefits based on the disability of the mother's or father's child who has attained age 16, or benefits under title XVIII based on disability, and

"(ii) the physical or mental impairment on the basis of which such benefits are payable is determined by a State agency (or the Secretary in a case to which subsection (g) applies) to have ceased, not to have existed, or to no longer be disabling,

such individual shall be entitled to notice and opportunity for review as provided in this paragraph.

"(B)(i) Any determination referred to in subparagraph (A)(ii)—

"(I) which has been prepared for issuance under this section by a State agency (or the Secretary) for the purpose of providing a basis for a decision of the Secretary with regard to the individual's continued rights to benefits under this title (including any decision as to whether an individual's rights to benefits are terminated or otherwise changed), and

"(II) which is in whole or in part unfavorable to such individual,

shall remain pending until after the notice and opportunity for review provided in this subparagraph.

"(ii) Any such pending determination shall contain a statement of the case, in understandable language, setting forth a discussion of the evidence and stating such determination, the reason or reasons upon which such determination is based, the right to a review of such determination (including the right to make a personal appearance as provided in this subparagraph), the right to submit additional evidence prior to or during such review as provided in this clause, and that, if such review is not requested, the individual will not be entitled to a hearing on such determination and such determination will be the disability determination upon which the final decision of the Secretary on entitlement will be based. Such statement of the case shall be transmitted in writing to such individual. Upon request by any such individual, or by a wife, divorced wife, widow, surviving divorced wife, surviving divorced mother, husband, divorced husband, widower, surviving divorced husband, surviving divorced father, child, or parent, who makes a showing in writing that his or her rights may be prejudiced by such determination, he or she shall be entitled to a review by the State agency (or the Secretary in a case to which subsection (g) applies) of such determination, including the right of such individual to make a personal appearance, and may submit additional evidence for purposes of such review prior to or during such review. Any such request must be filed within 30 days after notice of the pending determination is received by the individual making such request. Any review carried out by a State agency under this subparagraph shall be made in accordance with the pertinent provisions of this title and regulations thereunder.

"(iii) A review under this subparagraph shall include a review of evidence and medical history in the record at the time such disability determination is pending, shall examine any new medical evidence submitted or obtained for purposes of the review, and shall afford the individual requesting the review the opportunity to make a personal appearance with respect to the case at a place which is reasonably accessible to such individual.

"(iv) On the basis of the review carried out under this subparagraph, the State agency (or the Secretary in a case to which subsection (g) applies) shall affirm or modify the pending determination and issue the pending determination, as so affirmed or modified, as the disability determination under subsection (a), (c), (g), or (h) (as applicable).

"(C) Any disability determination described in subparagraph (A)(ii) which is issued by the State agency (or the Secretary) and which is in whole or in part unfavorable to the individual requesting the review shall contain a statement of the case, in understandable language, setting forth a discussion of the evidence, and stating the determination, the reason or reasons upon which the determination is based, the right (in the case of an individual who has exercised the right to review under subparagraph (B)) of such individual to a hearing under subparagraph (D), and the right to submit additional evidence prior to or at such a hearing. Such statement of the case shall be transmitted in writing to such individual and his or her representative (if any).

"(D)(i) An individual who has exercised the right to review under subparagraph (B) and who is dissatisfied with the disability determination referred to in subparagraph (C) shall be entitled to a hearing thereon to the same extent as is provided in section 205(b) with respect to decisions of the Secretary on which hearings are required under such section, and to judicial review of the Secretary's final decision after such hearing as is provided in section 205(g). Nothing in this section shall be construed to deny an individual his or her right to notice and opportunity for hearing under section 205(b) with respect to matters other than the determination referred to in subparagraph (A)(ii).

"(ii) Any hearing referred to in clause (i) shall be held before an administrative law judge who has been duly appointed in accordance with section 3105 of title 5, United States Code.".

(2) Section 205(b)(1) of such Act is amended by inserting after the fourth sentence the following new sentence: "Reviews of disability determinations on which decisions relating to continued entitlement to benefits are based shall be governed by the provisions of section 221(d)(2).".

(b)(1) Section 205(b) of such Act (as amended by subsection (a)(2)) is further amended—

(A) by striking out "(1)" after "(b)"; and

(B) by striking out paragraph (2).

(2) Section 4 of Public Law 97–455 (relating to evidentiary hearings in reconsiderations of disability benefit terminations) (96 Stat. 2499) and section 5 of such Act (relating to conduct of face-to-face reconsiderations in disability cases) (96 Stat. 2500) are repealed.

(c) Section 223(g) of the Social Security Act (as amended by section 913(a) of this Act) is further amended—

(1) in paragraph (1)(C), by striking out "for a hearing under section 221(d), or for an administrative review prior to such hearing" and inserting in lieu thereof "for review under section 221(d)(2)(B) or for a hearing under section 221(d)(2)(D)";

(2) in paragraph (1)(ii), by striking out "a hearing or an administrative review" and inserting in lieu thereof "review or a hearing"; and

(3) in paragraph (3), by striking out "a hearing under section 221(d), or for an administrative review prior to such hearing" and inserting in lieu thereof "review under section 221(d)(2)(B) or for a hearing under section 221(d)(2)(D)".

(d) The amendments made by this section shall apply with respect to determinations (referred to in section 221(d)(2)(A)(ii) of the Social Security Act (as amended by this section)), and determinations under the corresponding requirements established for disability determinations and reviews under title XVI of such Act, which are issued after December 31, 1984.

(e) The Secretary of Health and Human Services shall, as soon as practicable after the date of the enactment of this Act, implement as demonstration projects the amendments made by this section with respect to all disability determinations under subsections (a), (c), (g), and (h) of section 221 of the Social Security Act, and with respect to all disability determinations under title XVI of such Act in the same manner and to the same extent as is provided in such amendments with respect to determinations referred to in section 221(d)(2)(A)(ii) of such Act (as amended by this section).

Such demonstration projects shall be conducted in not fewer than five States. The Secretary shall report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate concerning such demonstration projects, together with any recommendations, not later than April 1, 1985.

SEC. 913. CONTINUATION OF BENEFITS DURING APPEAL.

(a)(1) Section 223(g)(1) of the Social Security Act is amended—

(A) in the matter following subparagraph (C), by striking out "and the payment of any other benefits under this Act based on such individual's wages and self-employment income (including benefits under title XVIII)," and inserting in lieu thereof ", the payment of any other benefits under this title based on such individual's wages and self-employment income, the payment of mother's or father's insurance benefits to such individual's mother or father based on the disability of such individual as a child who has attained age 16, and the payment of benefits under title XVIII based on such individual's disability,";

(B) in clause (i), by inserting "or" after "hearing,"; and

(C) by striking out ", or (iii) June 1984".

(2) Section 223(g)(3) of such Act is amended by striking out "which are made" and all that follows down through the end thereof and inserting in lieu thereof the following: "which are made on or after the date of the enactment of this subsection, or prior to such date but only on the basis of a timely request for a hearing under section 221(d), or for an administrative review prior to such hearing.".

(b) Section 1631(a) of such Act is amended by adding at the end thereof the following new paragraph:

"(7)(A) In any case where—

"(i) an individual is a recipient of benefits based on disability or blindness under this title,

"(ii) the physical or mental impairment on the basis of which such benefits are payable is found to have ceased, not to have existed, or to no longer be disabling, and as a consequence such individual is determined not to be entitled to such benefits, and

"(iii) a timely request for review or for a hearing is pending with respect to the determination that he is not so entitled,

such individual may elect (in such manner and form and within such time as the Secretary shall by regulations prescribe) to have the payment of such benefits continued for an additional period beginning with the first month beginning after the date of the enactment of this paragraph for which (under such determination) such benefits are no longer otherwise payable, and ending with the earlier of (I) the month preceding the month in which a decision is made after such a hearing, or (II) the month preceding the month in which no such request for review or a hearing is pending.

"(B)(i) If an individual elects to have the payment of his benefits continued for an additional period under subparagraph (A), and the final decision of the Secretary affirms the determination that he is not entitled to such benefits, any benefits paid under this title pursuant to such election (for months in such additional period) shall be considered overpayments for all purposes of this title, except as otherwise provided in clause (ii).

"(ii) If the Secretary determines that the individual's appeal of his termination of benefits was made in good faith, all of the benefits paid pursuant to such individual's election under subparagraph (A) shall be subject to waiver consideration under the provisions of subsection (b)(1).

"(C) The provisions of subparagraphs (A) and (B) shall apply with respect to determinations (that individuals are not entitled to benefits) which are made on or after the date of the enactment of this paragraph, or prior to such date but only on the basis of a timely request for review or for a hearing.".

(c)(1) The Secretary of Health and Human Services shall, as soon as practicable after the date of the enactment of this Act, conduct a study concerning the effect which the enactment and continued operation of section 223(g) of the Social Security Act is having on expenditures from the Federal Old-Age and Survivors Insurance Trust Fund, the Federal Disability Insurance Trust Fund, the Federal Hospital Insurance Trust Fund, and the Federal Supplementary Medical Insurance Trust Fund, and the rate of appeals to administrative law judges of unfavorable determinations relating to disability or periods of disability.

(2) The Secretary shall submit the results of the study under paragraph (1), together with any recommendations, to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate not later than July 1, 1986.

SEC. 914. QUALIFICATIONS OF MEDICAL PROFESSIONALS EVALUATING MENTAL IMPAIRMENTS.

Section 221 of the Social Security Act is amended—

(1) by redesignating subsection (i) as subsection (h); and

(2) by adding at the end thereof the following new subsection:

"(i) A determination under subsection (a), (c), (g), or (h) that an individual is not under a disability by reason of a mental impairment shall be made only if, before its issuance by the State (or the Secretary), a qualified psychiatrist or psychologist who is employed by the State agency or the Secretary (or whose services are contracted for by the State agency or the Secretary) has completed the medical portion of the case review, including any applicable residual functional capacity assessment.".

SEC. 915. REGULATORY STANDARDS FOR CONSULTATIVE EXAMINATIONS.

Section 221 of the Social Security Act (as amended by section 914 of this Act) is further amended by adding at the end thereof the following new subsection:

"(j) The Secretary shall prescribe regulations which set forth, in detail—

"(1) the standards to be utilized by State disability determination services and Federal personnel in determining when a consultative examination should be obtained in connection with disability determinations;

"(2) standards for the type of referral to be made; and

"(3) procedures by which the Secretary will monitor both the referral processes used and the product of professionals to whom cases are referred.

Nothing in this subsection shall be construed to preclude the issuance, in accordance with section 553(b)(A) of title 5, United States Code, of interpretive rules, general statements of policy, and rules of agency organization relating to consultative examinations if such rules and statements are consistent with such regulations.".

Subtitle C—Miscellaneous Provisions

SEC. 921. ADMINISTRATIVE PROCEDURE AND UNIFORM STANDARDS.

(a) Section 205(b) of the Social Security Act (as amended by sections 912(a)(2) and 912(b)(1) of this Act) is further amended—

(1) by inserting "(1)" after "(b)"; and

(2) by adding at the end thereof the following new paragraph:

"(2) Notwithstanding subsection (a)(2) of section 553 of title 5, United States Code, the rulemaking requirements of subsections (b) through (e) of such section shall apply to matters relating to benefits under this title. With respect to matters to which rulemaking requirements under the preceding sentence apply, only those rules prescribed pursuant to subsections (b) through (e) of such section 553 and related provisions governing notice and comment rulemaking under subchapter II of chapter 5 of such title 5 (relating to administrative procedure) shall be binding at any level of review by a State agency or the Secretary, including any hearing before an administrative law judge.".

(b) Section 1631(d)(1) of such Act is amended by inserting "(b)(2)," after "(a),".

SEC. 922. COMPLIANCE WITH COURT OF APPEALS DECISIONS.

(a) Title II of the Social Security Act is amended by adding at the end the following new section:

"COMPLIANCE WITH COURT OF APPEALS DECISIONS

"SEC. 234. (a) Except as provided in subsection (b), if, in any decision in a case to which the Department of Health and Human Services or an officer or employee thereof is a party, a United States court of appeals—

"(1) interprets a provision of this title or of any regulation prescribed under this title, and

"(2) requires such Department or such officer or employee to apply or carry out the provision in a manner which varies from the manner in which the provision is generally applied or carried out in the circuit involved,

the Secretary shall acquiesce in the decision and apply the interpretation with respect to all individuals and circumstances covered by the provision in the circuit until a different result is reached by a ruling by the Supreme Court of the United States on the issue involved or by a subsequently enacted provision of Federal law.

"(b) Acquiescence shall not be required under subsection (a) during the pendency of any direct appeal of the case by the Secretary under section 1252 of title 28, United States Code, or any request for review of the case by the Secretary under section 1254 of such title if such direct appeal or request for review is filed during the period of time allowed for such filing. If the Supreme Court finds that the requirements for the direct appeal under such section 1252 have not been met or denies a request for review under such section 1254, the Secretary shall resume acquiescence in the decision of the court of appeals in accordance with subsection (a) from the date of such finding or denial.".

(b) Section 1633 of such Act is amended by adding at the end thereof the following new subsection:

"(c) Section 234 shall apply with respect to decisions of United States courts of appeals involving interpretations of provisions of this title or of regulations prescribed under this title (and requiring action with respect to such provisions) in the same manner and to the same extent as it applies with respect to decisions involving interpretations of provisions of title II or of regulations prescribed thereunder (and requiring action with respect to such provisions).".

(c) The amendments made by subsections (a) and (b) of this section shall not apply with respect to a decision by a United States court of appeals in any case if the period allowed for filing the direct appeal or request for review of the case with the Supreme Court of the United States expired before the date of the enactment of this Act.

SEC. 923. PAYMENT OF COSTS OF REHABILITATION SERVICES.

(a) The first sentence of section 222(d)(1) of the Social Security Act is amended—

(1) by striking out "into substantial gainful activity"; and

(2) by striking out "which result in their performance of substantial gainful activity which lasts for a continuous period of nine months" and inserting in lieu thereof the following: "(i) in cases where the furnishing of such services results in the performance by such individuals of substantial gainful activity for a continuous period of nine months, (ii) in cases where such individuals receive benefits as a result of section 225(b) (except that no reimbursement under this paragraph shall be made for services furnished to any individual receiving such benefits for any period after the close of such individual's ninth consecutive month of substantial gainful activity or the close of the month in which his or her entitlement to such benefits ceases, whichever first occurs), and (iii) in cases where such individuals, without good cause, refuse to accept vocational rehabilitation services or fail to cooperate in such a manner as to preclude their successful rehabilitation".

(b) The second sentence of section 222(d)(1) of such Act is amended by inserting after "substantial gainful activity" the following: ", the determination that an individual, without good cause, refused to accept vocational rehabilitation services or failed to cooperate in such a manner as to preclude successful rehabilitation,".

(c) The first sentence of section 1615(d) of such Act is amended by striking out "if such services result in their performance of substantial gainful activity which lasts for a continuous period of nine months" and inserting in lieu thereof the following: "(1) in cases where the furnishing of such services results in the performance by such individuals of substantial gainful activity for continuous periods of nine months, (2) in cases where such individuals are determined to be no longer entitled to benefits under this title because the physical or mental impairments on which the benefits are based have ceased, do not exist, or are not disabling (and no reimbursement under this subsection shall be made for services furnished to any individual receiving such benefits for any period after the close of such individual's ninth consecutive month of substantial gainful activity or the close of the month with which his or her entitlement to such benefits ceases, whichever first occurs), and (3) in cases where such individuals, without good cause, refuse to accept vocational rehabilitation services or fail to cooperate in such a manner as to preclude their successful rehabilitation".

(d) The amendments made by this section shall apply with respect to individuals who receive benefits as a result of section 225(b) of the Social Security Act (or who are determined to be no longer entitled to benefits under title XVI of such Act because the physical or mental impairments on which the benefits are based have ceased, do not exist, or are not disabling), or who refuse to accept rehabilitation services or fail to cooperate in an approved vocational rehabilitation program, in or after the first month following the month in which this Act is enacted.

SEC. 924. ADVISORY COUNCIL ON MEDICAL ASPECTS OF DISABILITY.

(a) There is hereby established in the Department of Health and Human Services an Advisory Council on the Medical Aspects of Disability (hereafter in this section referred to as the "Council").

(b)(1) The Council shall consist of—

(A) 10 members appointed by the Secretary of Health and Human Services (without regard to the requirements of the Federal Advisory Committee Act) within 60 days after the date of the enactment of this Act from among independent medical and vocational experts, including at least one psychiatrist, one rehabilitation psychologist, and one medical social worker; and

(B) the Commissioner of Social Security ex officio.

The Secretary shall from time to time appoint one of the members to serve as Chairman. The Council shall meet as often as the Secretary deems necessary, but not less often than twice each year.

(2) Members of the Council appointed under paragraph (1)(A) shall be appointed without regard to the provisions of title 5, United States Code, governing appointments in the competitive service. Such members, while attending meetings or conferences thereof or otherwise serving on the business of the Council, shall be paid at rates fixed by the Secretary, but not exceeding $100 for each day, including traveltime, during which they are engaged in the actual performance of duties vested in the Council; and while so serving away from their homes or regular places of business they may be allowed travel expenses, including per diem in lieu of subsistence, as authorized by section 5703 of title 5, United States Code, for persons in the Government service employed intermittently.

(3) The Council may engage such technical assistance from individuals skilled in medical and other aspects of disability as may be necessary to carry out its functions. The Secretary shall make available to the Council such secretarial, clerical, and other assistance and any pertinent data pre-

pared by the Department of Health and Human Services as the Council may require to carry out its functions.

(c) It shall be the function of the Council to provide advice and recommendations to the Secretary of Health and Human Services on disability standards, policies, and procedures under titles II and XVI of the Social Security Act, including advice and recommendations with respect to—

(1) the revisions to be made by the Secretary, under section 911(a) of this Act, in the criteria embodied under the category "Mental Disorders" in the "Listing of Impairments"; and

(2) the question of requiring, in cases involving impairments other than mental impairments, that the medical portion of each case review (as well as any applicable assessment of residual functional capacity) be completed by an appropriate medical specialist employed by the State agency before any determination can be made with respect to the impairment involved.

The Council shall also have the functions and responsibilities (with respect to work evaluations in the case of applicants for and recipients of benefits based on disability under title XVI) which are set forth in section 927 of this Act.

(d) Whenever the Council deems it necessary or desirable to obtain assistance in order to perform its functions under this section, the Council may—

(1) call together larger groups of experts, including representatives of appropriate professional and consumer organizations, in order to obtain a broad expression of views on the issues involved; and

(2) establish temporary short-term task forces of experts to consider and comment upon specialized issues.

(e)(1) Any advice and recommendations provided by the Council to the Secretary of Health and Human Services shall be included in the ensuing annual report made by the Secretary to Congress under section 704 of the Social Security Act.

(2) Section 704 of the Social Security Act is amended by inserting after the first sentence the following new sentence: "Each such report shall contain a comprehensive description of the current status of the disability insurance program under title II and the program of benefits for the blind and disabled under title XVI (including, in the case of the reports made in 1984, 1985, and 1986, any advice and recommendations provided to the Secretary by the Advisory Council on the Medical Aspects of Disability, with respect to disability standards, policies, and procedures, during the preceding year).".

(f) The Council shall cease to exist at the close of December 31, 1985.

SEC. 925. QUALIFYING EXPERIENCE FOR APPOINTMENT OF CERTAIN STAFF ATTORNEYS TO ADMINISTRATIVE LAW JUDGE POSITIONS.

(a)(1) The Secretary of Health and Human Services shall, within 180 days after the date of the enactment of this Act, establish a sufficient number of attorney adviser positions at grades GS–13 and GS–14 in the Department of Health and Human Services to ensure adequate opportunity for career advancement for attorneys employed by the Social Security Administration in the process of adjudicating claims under section 205(b), 221(d), or 1631(c) of the Social Security Act. In assigning duties and responsibilities to such a position, the Secretary shall assign duties and responsibilities to enable an individual serving in such a position to achieve qualifying experience for appointment by the Secretary for the position of administrative law judge under section 3105 of title 5, United States Code.

(b) The Secretary of Health and Human Services shall—

(1) within 90 days after the date of the enactment of this Act, submit an interim report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate on the Secretary's progress in meeting the requirements of subsection (a), and

(2) within 180 days after the date of the enactment of this Act, submit a final report to such committees setting forth specifically the manner and extent to which the Secretary has complied with the requirements of subsection (a).

SEC. 926. SSI BENEFITS FOR INDIVIDUALS WHO PERFORM SUBSTANTIAL GAINFUL ACTIVITY DESPITE SEVERE MEDICAL IMPAIRMENT.

(a) Section 201(d) of the Social Security Disability Amendments of 1980 is amended by striking out "shall remain in effect only for a period of three years after such effective date" and inserting in lieu thereof "shall remain in effect only through June 30, 1986".

(b) Section 1619 of the Social Security Act is amended by adding at the end thereof the following new subsection:

"(c) The Secretary of Health and Human Services and the Secretary of Education shall jointly develop and disseminate information, and establish training programs for staff personnel, with respect to the potential availability of benefits and services for disabled individuals under the provisions of this section. The Secretary of Health and Human Services shall provide such information to individuals who are applicants for and recipients of benefits based on disability under this title and shall conduct such programs for the staffs of the District offices of the Social Security Administration. The

Secretary of Education shall conduct such programs for the staffs of the State Vocational Rehabilitation agencies, and in cooperation with such agencies shall also provide such information to other appropriate individuals and to public and private organizations and agencies which are concerned with rehabilitation and social services or which represent the disabled.".

SEC. 927. ADDITIONAL FUNCTIONS OF ADVISORY COUNCIL; WORK EVALUATIONS IN CASE OF APPLICANTS FOR AND RECIPIENTS OF SSI BENEFITS BASED ON DISABILITY.

The functions and responsibilities of the Advisory Council on the Medical Aspects of Disability (established by section 924 of this Act) shall include—

(1) a consideration of alternative approaches to work evaluation in the case of applicants for benefits based on disability under title XVI and recipients of such benefits undergoing reviews of their cases, including immediate referral of any such applicant or recipient to a vocational rehabilitation agency for services at the same time he or she is referred to the appropriate State agency for a disability determination;

(2) an examination of the feasibility and appropriateness of providing work evaluation stipends for applicants for and recipients of benefits based on disability

under title XVI in cases where extended work evaluation is needed prior to the final determination of their eligibility for such benefits or for further rehabilitation and related services;

(3) a review of the standards, policies, and procedures which are applied or used by the Secretary of Health and Human Services with respect to work evaluations, in order to determine whether such standards, policies, and procedures will provide appropriate screening criteria for work evaluation referrals in the case of applicants for and recipients of benefits based on disability under title XVI; and

(4) an examination of possible criteria for assessing the probability that an applicant for or recipient of benefits based on disability under title XVI will benefit from rehabilitation services, taking into consideration not only whether the individual involved will be able after rehabilitation to engage in substantial gainful activity but also whether rehabilitation services can reasonably be expected to improve the individual's functioning so that he or she will be able to live independently or work in a sheltered environment.

For purposes of this section, "work evaluation" includes (with respect to any individual) a determination of (A) such individual's skills, (B) the work activities or types of work activity for which such individual's skills are insufficient or inadequate, (C) the work activities or types of work activity for which such individual might potentially be trained or rehabilitated, (D) the length of time for which such individual is capable of sustaining work (including, in the case of the mentally impaired, the ability to cope with the stress of competitive work), and (E) any modifications which may be necessary, in work activities for which such individual might be trained or rehabilitated, in order to enable him or her to perform such activities.

SEC. 928. EFFECTIVE DATE.

Except as otherwise provided in this title, the amendments made by this title shall apply only with respect to cases involving disability determinations pending in the Department of Health and Human Services or in court on the date of the enactment of this Act, or initiated on or after such date.

TITLE X—MEDICARE BUDGET RECONCILIATION AMENDMENTS

SHORT TITLE; TABLE OF CONTENTS

SEC. 1000. This title may be cited as the "Medicare Budget Reconciliation Amendments of 1984".

TABLE OF CONTENTS

PART A—PAYMENT AND COVERAGE-RELATED CHANGES

Sec. 1001. Payment for outpatient diagnostic laboratory tests.
Sec. 1002. Coverage of administration of hepatitis B vaccine.
Sec. 1003. Pacemaker reimbursement review and reform.
Sec. 1004. Payment for debridement of mycotic toenails.

Sec. 1005. Payment for costs of hospital-based mobile intensive care units.
Sec. 1006. Payment for physicians' services furnished to hospital inpatients.

PART B—MISCELLANEOUS ADMINISTRATIVE CHANGES

Sec. 1021. Presidential appointment of pay level for the administrator of the Health Care Financing Administration.
Sec. 1022. Permitting limited provider representation on peer review organizations.
Sec. 1023. Access to home health services.
Sec. 1024. Repeal of special tuberculosis treatment requirements.
Sec. 1025. Indirect payment of supplementary medical insurance benefits.
Sec. 1026. Including podiatrists in definition of "physician" for outpatient physical therapy services and including podiatrists and dentists in definition of "physician" for outpatient ambulatory surgery.
Sec. 1027. Establishment by physical therapists of plans for physical therapy.
Sec. 1028. Access to records of subcontractors.
Sec. 1029. Medicare recovery against certain third parties.
Sec. 1030. Use of accrediting organizations for certain entities furnishing services.
Sec. 1031. Confidentiality of accreditation surveys.
Sec. 1032. Thirty-day coverage for services furnished by a home health agency whose agreement has been terminated.
Sec. 1033. Termination of agreements with institutions and entities where owners or certain other individuals have been convicted of certain offenses.
Sec. 1034. Elimination of health insurance benefits advisory council.
Sec. 1035. Open enrollment periods for health maintenance organizations and competitive medical plans.
Sec. 1036. Deadline for report on including payment for physicians' services to hospital inpatients in DRG payment amounts.
Sec. 1037. Flexible sanctions for noncompliance with requirements for end-stage renal disease facilities.
Sec. 1038. Removing costs of nurse anesthetists from DRG based payments.
Sec. 1039. Determination of hospital area wage index.
Sec. 1040. Definition of bona fide emergency services for purposes of limitations on payment for hospital outpatient services.
Sec. 1041. Delay of effective date for single-rate for skilled nursing facilities.

PART A—PAYMENT- AND COVERAGE-RELATED CHANGES

PAYMENT FOR OUTPATIENT DIAGNOSTIC LABORATORY TESTS

SEC. 1001. (a) Subsection (a) of section 1833 of the Social Security Act (42 U.S.C. 13951) is amended—

(1) by amending clause (D) of subsection (a)(1) to read as follows: "(D) with respect to diagnostic laboratory tests for which payment is made under this part, the amounts paid shall be equal to 80 percent (or 100

percent, in the case of such tests for which payment is made on the basis of an assignment described in section 1842(b)(3)(B)(ii) or under the procedure described in section 1870(f)(1)) of the lesser of (i) the amount determined under subsection (h), or (ii) the amount of the charges billed for the tests;";

(2) by inserting "or (D)" in paragraph (2)(B) after "subparagraph (C)";

(3) by striking out "and" at the end of paragraph (2)(B);

(4) by inserting "and" at the end of paragraph (2)(C); and

(5) by adding at the end of paragraph (2) the following new subparagraph:

"(D) with respect to diagnostic laboratory tests for which payment is made under this part, 100 percent of the lesser of (i) the amount determined under subsection (h), or (ii) the amount of the charges billed for the tests;".

(b) Subsection (b) of such section is amended—

(1) by striking out "and" at the end of clause (2) of subsection (b); and

(2) by inserting before the period at the end of the first sentence of subsection (b) the following: ", and (4) such deductible shall not apply with respect to diagnos-

tic laboratory tests for which payment is made under this part on the basis of an assignment described in section 1842(b)(3)(B)(ii), under the procedure described in section 1870(f)(1), or to a provider of services with an agreement in effect under section 1866".

(c) Subsection (h) of such section is amended to read as follows:

"(h)(1) The Secretary shall establish in accordance with this subsection a national fee schedule for diagnostic laboratory tests for which payment is made under this part.

"(2) Except as provided in paragraph (4), the Secretary shall set the fee schedule at 60 percent of the prevailing charge level determined pursuant to the third and fourth sentences of section 1842(b)(3) for similar diagnostic laboratory tests for the 12-month period beginning July 1, 1984, adjusted annually to reflect changes in the Consumer Price Index for All Urban Consumers (United States city average) and subject to such other adjustments as the Secretary determines are justified by technological changes.

"(3) In addition to the amounts provided under the fee schedule, the Secretary shall provide for and establish a nominal fee to cover the costs in collecting the sample on a diagnostic laboratory test that was performed and for which payment is made under this part, except that not more than one such fee may be provided under this paragraph with respect to samples collected in the same encounter.

"(4)(A) During the 3-year period beginning July 1, 1984, the Secretary may provide for the fee schedule under this subsection to be established on a regional or statewide basis if the Secretary determines that a national fee schedule is inappropriate at such time because of limitations in the data available to establish such a schedule.

"(B) In establishing a fee schedule under this subsection, the Secretary may provide for an adjustment to take into account, with respect to the portion of the expenses of diagnostic laboratory tests attributable to wages, the relative difference between a region's or local area's wage rates and the wage rate presumed in the data on which the schedule is based.

"(5) In the case of a bill or request for payment for a diagnostic laboratory test for which payment may otherwise be made under this part—

"(A) no payment may be made under this part to a physician with respect to such test unless the physician (or another physician with whom the physician shares his practice) personally performed or supervised the performance of the test, and

"(B) payment for such a test performed by a laboratory which is independent of a physician's office or a rural health clinic may only be made on the basis of an assignment described in section 1842(b)(3)(B)(ii), under the procedure described in section 1870(f)(1), or to a provider of services with an agreement in effect under section 1866.".

(d) Section 1842(h) of such Act (42 U.S.C. 1395u(h)) is repealed.

(e) The last sentence of section 1866(a)(2)(A) of such Act (42 U.S.C. 1395cc(a)(2)(A)) is amended by inserting "and with respect to diagnostic laboratory tests" after "section 1861(s)(10)".

(f) The Secretary of Health and Human Services (hereinafter in this title referred to as the "Secretary") shall simplify the procedures under section 1842 of the Social Security Act with respect to claims and payments for diagnostic laboratory tests under part B of title XVIII of such Act.

(g) The amendments and repeal made by this section shall apply to diagnostic laboratory tests furnished on or after July 1, 1984.

COVERAGE OF ADMINISTRATION OF HEPATITIS B VACCINE

SEC. 1002. (a) Section 1861(s)(10) of the Social Security Act (42 U.S.C. 1395x(s)(10)) is amended—

(1) by inserting "(A)" after "(10)",

(2) by striking out the period at the end and inserting in lieu thereof "; and", and

(3) by adding at the end the following new subparagraph:

"(B) hepatitis B vaccine and its administration, furnished in a hospital or a renal dialysis facility.".

(b) Section 1833 of such Act (42 U.S.C. 13951) is amended by adding at the end the following new subsection:

"(k) With respect to services described in section 1861(s)(10)(B), the Secretary may provide, instead of the amount of payment otherwise provided under this part, for payment of such an amount or amounts as reasonably reflects the general cost of efficiently providing such services.".

(c) The amendments made by this section apply to services furnished on or after July 1, 1984.

PACEMAKER REIMBURSEMENT REVIEW AND REFORM

SEC. 1003. (a)(1) The Secretary shall issue revisions to the current guidelines for the payment under part B of title XVIII of the Social Security Act for the transtelephonic monitoring of cardiac pacemakers. Such revised guidelines shall include provisions regarding the specifications for and frequency of transtelephonic monitoring procedures which will be found to be reasonable and necessary.

(2)(A) Except as provided in subparagraph (B), if the guidelines required by paragraph (1) have not been issued and put into effect by October 1, 1984, payment may not be made under part B of title XVIII of the Social Security Act for transtelephonic monitoring procedures (with respect to a single-chamber cardiac pacemaker powered by lithium batteries) conducted more frequently than—

(i) weekly during the first month after implantation,

(ii) once every 2 months during the period representing 80 percent of the estimated life of the implanted device, and

(iii) monthly thereafter.

(B) Subparagraph (A) shall only apply to the monitoring of single-chamber cardiac pacemaker devices powered by lithium batteries, and shall not apply in cases where the Secretary (or the Secretary's agent) determines that special medical factors (including possible evidence of pacemaker malfunction) justify more frequent transtelephonic monitoring procedures.

(b)(1) The Secretary shall review, and report to the Committees on Energy and Commerce and Ways and Means of the House of Representatives and the Committee on Finance of the Senate, regarding the appropriateness of the current rate of reimbursement under part B of title XVIII of the Social Security Act for physicians' services associated with implantation or replacement of pacemaker devices and pacemaker leads. Such review shall take into account the amounts recognized as reasonable with respect to such procedures and the time and difficulty of such procedures at the current time in comparison with such amounts and the time and difficulty of such procedures at the time the rates for such procedures were first established under such part. In making such review and report, the Secretary shall take into consideration the reduction of such recognized rates by 20 percent.

(2) The Secretary shall complete the review described in this subsection not later than October 1, 1984.

(c) Section 1866 of the Social Security Act (42 U.S.C. 1395cc) is amended by adding at the end thereof the following new subsection:

"(g)(1) The Secretary shall, through the Commissioner of the Food and Drug Administration, provide for a registry of all cardiac pacemaker devices and pacemaker leads for which payment was made under this title. Such registry shall include the manufacturer, model, serial number, and manufacturer's price of each such device or lead, the name of the recipient of such device or lead, the date and location of the implantation or removal of the device or lead, the name of the physician involved in implanting or removing such device or lead, the name of the hospital or other provider billing for such procedure, any express or implied warranties associated with such device or lead under contract or State law, and such other information as the Secretary deems to be appropriate. Such registry shall be for the purposes of assisting the Secretary in determining when payments may properly be made under this title, determining when inspection by the Food and Drug Administration may be necessary under paragraph (2), and carrying out studies with respect to the use of such devices and leads. In carrying out any such study, the Secretary may not reveal any specific information which identifies any pacemaker device or lead recipient by name (or which would otherwise identify a specific recipient). Any person or organization may provide information to the registry with respect to cardiac pacemaker devices and leads other than those for which payment is made under this title.

"(2) In any case where the Secretary has reason to believe, based upon information in the pacemaker registry or otherwise available to him, that replacement of a cardiac pacemaker device or lead for which payment is or may be requested under this title is related to the malfunction of a device or lead, the Secretary may require that personnel of the Food and Drug Administration test such device, or be present at the testing of such device by the manufacturer, to determine whether such device was functioning properly.".

PAYMENT FOR DEBRIDEMENT OF MYCOTIC TOENAILS

SEC. 1004. The Secretary shall provide, pursuant to section 1862(a) of the Social Security Act, that payment will not be made under part B of title XVIII of such Act for a physician's debridement of mycotic toenails to the extent such debridement is performed for a patient more frequently than once every 60 days, unless the medical necessity for more frequent treatment is documented by the billing physician.

PAYMENT FOR COSTS OF HOSPITAL-BASED MOBILE INTENSIVE CARE UNITS

SEC. 1005. (a)(1) In the case of a project or system described in subsection (b), the Secretary shall provide, except as provided in paragraph (2), that the amount of payments to hospitals covered under the project or system (on and after January 1, 1983) shall include payments for their operation of hospital-based mobile intensive care units (as defined by State statute) if the State provides satisfactory assurances that the total amount of payments to such hospitals under titles XVIII and XIX of the Social Security Act under the demonstration project or system (including any such additional amount of payment) would not exceed the total amount of payments which would have been paid under such titles if the demonstration project or system were not in effect.

(2) Paragraph (1) shall not apply if the State in which the project or system is located notifies the Secretary—

(A) within 30 days of the date of the enactment of this section, in the case of a demonstration project described in subsection (b)(1), or

(B) within a reasonable period (established by the Secretary), in the case of a system described in subsection (b)(2),

that the State does not want paragraph (1) to apply to that project or system.

(b) A project or system referred to in subsection (a) is—

(1) a statewide demonstration project under section 222(a) of the Social Security Amendments of 1972 (Public Law 92–603), or

(2) a statewide hospital reimbursement control system approved under section 1886(c) of the Social Security Act,

which project or system provides for payments to hospitals in a State determined on a prospective basis and related to a classification of patients by diagnosis-related groups.

(c) Payment for services described in this section shall be considered to be payments for services under part A of title XVIII of the Social Security Act.

PAYMENT FOR PHYSICIANS' SERVICES FURNISHED TO HOSPITAL INPATIENTS

SEC. 1006. (a) Subsection (b) of section 1842 of the Social Security Act (42 U.S.C. 1395u) is amended by redesignating paragraphs (4) through (6) as paragraphs (5) through (7), respectively, and by inserting after paragraph (3) the following new paragraph:

"(4)(A) In determining the prevailing charge levels under the third and fourth sentences of paragraph (3) for physicians' services furnished to inpatients of a hospital, the Secretary shall not set any level higher than the same level as was set for the period ending June 30, 1984, in the case of the twelve-month period ending June 30, 1985.

"(B) In determining the prevailing charge levels under the third and fourth sentences of paragraph (3) for physicians' services furnished to inpatients of a hospital for periods beginning after June 30, 1985, the Secretary shall treat the levels as set under subparagraph (A) as having fully provided for economic changes which would have been taken into account but for the limitations contained in subparagraph (A).".

(b)(1) Section 1866(a)(1) of such Act (42 U.S.C. 1395cc(a)(1)) is amended by striking out "Any provider" and inserting in lieu thereof "Subject to paragraph (4), any provider".

(2) Section 1866(a) of such Act is further amended by inserting at the end the following new paragraph:

"(4)(A) A hospital shall be qualified to participate under this title and shall be eligible for payments under this title only if it provides (in the agreement filed with the Secretary under paragraph (1)) that any physician who—

"(i) is on the medical staff of the hospital (courtesy or otherwise) and

"(ii) furnishes services to inpatients in the hospital,

must enter into an agreement described in subparagraph (B) in a manner established by the Secretary.

"(B) A physician's agreement referred to in subparagraph (A) is an agreement by the physician not to impose any charge or receive payment for any services which are furnished to any inpatient in the hospital for which payment may be made under part B except on the basis of an assignment in section 1842(b)(3)(B)(ii) or under the procedure described in section 1870(f)(1).".

(3) Section 1866(b)(2) of such Act is amended by inserting before the period at the end thereof the following: ", or (H) that such provider (in the case of a hospital) is not complying with the provisions of the agreement specified in subsection (a)(4)".

(c)(1) The amendments made by subsection (a) shall be effective with respect to items and services furnished on or after July 1, 1984.

(2) The amendments made by subsection (b) shall only apply to physicians' services furnished during the period beginning on July 1, 1984, and ending six months after the date the Congress receives the report of the Secretary of

Health and Human Services under section 603(a)(2)(B) of the Social Security Amendments of 1983 (relating to a report on including payment for physicians' services to hospital inpatients in the DRG-based payment amount to hospitals).

(3) The Secretary of Health and Human Services shall provide for notice to individuals enrolled (or enrolling) under the supplementary medical insurance program under part B of title XVIII of the Social Security Act of the amendments made by subsection (b).

PART B—MISCELLANEOUS ADMINISTRATIVE CHANGES

PRESIDENTIAL APPOINTMENT OF AND PAY LEVEL FOR THE ADMINISTRATOR OF THE HEALTH CARE FINANCING ADMINISTRATION

SEC. 1021. (a) Title XI of the Social Security Act is amended by inserting after section 1116 the following new section:

"APPOINTMENT OF THE ADMINISTRATOR OF THE HEALTH CARE FINANCING ADMINISTRATION

"SEC. 1117. The Administrator of the Health Care Financing Administration shall be appointed by the President by and with the advice and consent of the Senate.".

(b) Section 5315 of title 5, United States Code, is amended by adding at the end thereof the following:

"Administrator of the Health Care Financing Administration.".

(c) The amendments made by this section shall apply to appointments made after the date of the enactment of this Act.

PERMITTING LIMITED PROVIDER REPRESENTATION ON PEER REVIEW ORGANIZATIONS

SEC. 1022. Section 1153(b)(3) of the Social Security Act (42 U.S.C. 1320c–2(b)(3)) is amended—

(1) by striking out "(3) The Secretary" and inserting in lieu thereof "(3)(A) Except as provided in subparagraph (B), the Secretary", and

(2) by adding at the end the following new subparagraph:

"(B) In the case of a utilization and quality control peer review organization with a governing board composed of—

"(i) not more than 15 members, the Secretary may enter into a contract under this part with the organization if not more than one of the members of its governing board is a member of a governing board, officer, or managing employee of a health care facility, or

"(ii) more than 15 members, the Secretary may enter into a contract under this part with the organization if not more than two of the members of its governing board are members of a governing board, officer, or managing employee of a health care facility.".

ACCESS TO HOME HEALTH SERVICES

SEC. 1023. (a) Sections 1814(a) and 1835(a) of the Social Security Act (42 U.S.C. 1395f(a), 1395n(a)) are each amended by adding at the end the following new sentence: "For purposes of the preceding sentence, service by a physician as an uncompensated officer or director of a home health agency shall not constitute having a significant ownership interest in, or a significant financial or contractual relationship with, such agency.".

(b) The third sentence of section 1814(a) of the Social Security Act (42 U.S.C. 1395f(a)) and the fourth sentence of section 1835(a) of such Act (42 U.S.C. 1395n(a)) are each amended by inserting before the period at the end the following: ", except that such prohibition shall not apply with respect to a home health agency which is a sole community home health agency (as determined by the Secretary)".

(c)(1) The amendments made by subsection (a) shall apply to certifications and plans of care made or established on or after the date of the enactment of this Act.

(2) The Secretary shall provide, not later than 90 days after the date of the enactment of this Act, for such revision of regulations as may be required to reflect the amendments made by subsection (b).

REPEAL OF SPECIAL TUBERCULOSIS TREATMENT REQUIREMENTS

SEC. 1024. (a) Section 1814(a) of the Social Security Act (42 U.S.C. 1395f(a)) is amended—

(1) by striking out subparagraph (B) of paragraph (2),

(2) by striking out "and inpatient tuberculosis hospital services" in paragraph (3),

(3) by striking out paragraph (5), and

(4) by striking out "(B)," in the sentence that follows paragraph (8).

(b) Section 1861 of such Act (42 U.S.C. 1395x) is amended—

(1) by striking out subsections (d) and (g),

(2) by striking out "or tuberculosis unless it is a tuberculosis hospital (as defined in subsection (g)) or" in the fifth sentence of subsection (e), and

(3) by striking out "or tuberculosis" in the first sentence of subsection (j) following paragraph (15).

(c) Section 1863 of such Act (42 U.S.C. 1395z) is amended by striking out "(g)(4),".

(d) Section 1866 of such Act (42 U.S.C. 1395cc) is amended—

(1) by striking out "tuberculosis hospital services and" in subsection (b)(3), and

(2) by striking out "inpatient tuberculosis hospital services and" in subsection (d).

INDIRECT PAYMENT OF SUPPLEMENTARY MEDICAL INSURANCE BENEFITS

SEC. 1025. (a) The first sentence of section 1842(b)(5) of the Social Security Act (42 U.S.C. 1395u(b)(5)) is amended—

(1) by inserting "(i)" after "(A)",

(2) by striking out "(B)" and inserting in lieu thereof "(ii)", and

(3) by inserting before the period the following: ", or (B) to an entity (i) which provides coverage of the services under a health benefits plan, but only to the extent that payment is not made under this part, (ii) which has paid the person who provided the service an amount (including the amount payable under this part) which that person has accepted as payment in full for the service, and (iii) to which the individual has agreed in writing that payment may be made under this part".

(b) The second sentence of such section is amended by striking out "or (B)".

INCLUDING PODIATRISTS IN DEFINITION OF "PHYSICIAN" FOR OUTPATIENT PHYSICAL THERAPY SERVICES AND INCLUDING PODIATRISTS AND DENTISTS IN DEFINITION OF "PHYSICIAN" FOR OUTPATIENT AMBULATORY SURGERY

SEC. 1026. (a) Section 1861(p)(1) of the Social Security Act (42 U.S.C. 1395x(p)(1)) is amended by striking out "section 1861(r)(1)" and inserting in lieu thereof "paragraph (1) or (3) of section 1861(r)".

(b) Section 1832(a)(2)(F)(ii) of such Act (42 U.S.C. 1395k(a)(2)(F)(ii)) is amended by striking out "section 1861(r)(1)" and inserting in lieu thereof "paragraph (1), (2), or (3) of section 1861(r)".

(c) Section 1861(r)(3) of such Act (42 U.S.C. 1395x(r)(3)) is amended—

(1) by striking out "and (m)" the first place it appears and inserting in lieu thereof ", (m), and (p)(1)", and

(2) by inserting ", 1832(a)(2)(F)(ii)," after "1814(a)" the first place it appears.

(d) The amendments made by this section apply to services furnished on or after the date of enactment of this Act.

ESTABLISHMENT BY PHYSICAL THERAPISTS OF PLANS FOR PHYSICAL THERAPY

SEC. 1027. (a) Section 1861(p)(2) of the Social Security Act (42 U.S.C. 1395x(p)(2)) is amended by striking out ", and is periodically reviewed, by a physician (as so defined)" and inserting in lieu thereof "by a physician (as so defined) or by a qualified physical therapist and is periodically reviewed by a physician (as so defined)".

(b) Section 1835(a)(2)(C)(ii) of such Act (42 U.S.C. 1395n(a)(2)(C)(ii)) is amended by striking out ", and is periodically reviewed, by a physician" and inserting in lieu thereof "by a physician or by the qualified physical therapist provided such services and is periodically reviewed by a physician".

(c) The amendments made by this section apply to plans of care established on or after the date of the enactment of this Act.

ACCESS TO RECORDS OF SUBCONTRACTORS

SEC. 1028. (a) Section 1861(v)(1)(I) of the Social Security Act (42 U.S.C. 1395x(v)(1)(I)) is amended by striking out "$10,000" and inserting in lieu thereof "$50,000".

(b) The amendment made by subsection (a) applies to contracts with subcontractors entered into on or after the date of the enactment of this Act.

MEDICARE RECOVERY AGAINST CERTAIN THIRD PARTIES

SEC. 1029. (a) Section 1862(b)(1) of the Social Security Act (42 U.S.C. 1395y(b)(1)) is amended—

(1) in the first sentence, by inserting "promptly" after "to be made",

(2) in the second sentence, by inserting "or may be" after "has been", and

(3) by inserting after the second sentence the following new sentence: "The United States may recover the amount of any such payment under this title by bringing an action against the entity responsible for payment under such a law, policy, plan, or insurance (if the entity would be required to make payment if an appropriate claim were pursued, but only to the extent that the entity has not already made payment), by bringing an action against the entity to which payment has been so made (if the entity is other than the individual entitled to benefits under this title), or by joining or intervening in any action related to the events that gave rise to the need for the item or service, and shall be subrogated (to the extent of the payment under this title) to any right of the individual or any other entity to payment under such a law, policy, plan, or insurance.".

(b) Section 1862(b)(2)(B) of such Act (42 U.S.C. 1395y(b)(2)(B)) is amended—

(1) in the first sentence, by inserting "or may be" after "has been", and

(2) by inserting after the first sentence the following new sentence: "The United States may recover the amount of any such payment under this title by bringing an action against the entity responsible for payment under such a plan (if the entity would be required to make payment if an appropriate claim were pursued, but only to the extent that the entity has not already made payment), by bringing an action against the entity to which payment has been so made (if the entity is other than the individual entitled to benefits under this title), or by joining or intervening in any action related to the events that gave rise to the need for the item or service, and shall be subrogated (to the extent of the payment under this title) to any right of the individual or any other entity to payment under such a plan.".

(c) Section 1862(b)(3)(A)(ii) of such Act (42 U.S.C. 1395y(b)(3)(A)(ii)) is amended—

(1) in the first sentence, by inserting "or may be" after "has been", and

(2) by inserting after the first sentence the following new sentence: "The United States may recover the amount of any such payment under this title by bringing an action against the entity responsible for payment under such a plan (if the entity would be required to make payment if an appropriate claim were pursued, but only to the extent that the entity has not already made payment), by bringing an action against the entity to which payment has been so made (if the entity is other than the individual entitled to benefits under this title), or by joining or intervening in any action related to the events that gave rise to the need for the item or service, and shall be subrogated (to the extent of the payment under this title) to any right of the individual or any other entity to payment under such a plan.".

USE OF ACCREDITING ORGANIZATIONS FOR CERTAIN ENTITIES FURNISHING SERVICES

SEC. 1030. The third sentence of section 1865(a) of the Social Security Act (42 U.S.C. 1395bb(a)) is amended—

(1) by striking out "section 1861(e), (j), (o), or (dd)" and inserting in lieu thereof "section 1832(a)(2)(F)(i), 1861(e), 1861(f), 1861(j), 1861(o), or 1861(p)(4)(A) or (B), paragraphs (11) and (12) of sec-

tion 1861(s), or section 1861(aa)(2), 1861(cc)(2), or 1861(dd)(2)", and

(2) by striking out "institution or agency" each place it appears and inserting in lieu thereof "entity".

CONFIDENTIALITY OF ACCREDITATION SURVEYS

SEC. 1031. Section 1865(a) of the Social Security Act (42 U.S.C. 1395bb(a)) is amended—

(1) by striking out "(on a confidential basis)" in paragraph (2), and

(2) by adding at the end the following new sentence:

"The Secretary may not disclose any accreditation survey made and released to him by the Joint Commission on Accreditation of Hospitals, the American Osteopathic Association, or any other national accreditation body, of an entity accredited by such body.".

THIRTY-DAY COVERAGE FOR SERVICES FURNISHED BY A HOME HEALTH AGENCY WHOSE AGREEMENT HAS BEEN TERMINATED

SEC. 1032. (a) Section 1866(b)(4)(B) of the Social Security Act (42 U.S.C. 1395cc(b)(4)(B)) is amended by striking out "the calendar year in which" and inserting in lieu thereof "30 days after".

(b) The amendment made by subsection (a) applies with respect to terminations whose effective date falls after 60 days after the date of the enactment of this Act.

TERMINATION OF AGREEMENTS WITH INSTITUTIONS AND ENTITIES WHERE OWNERS OR CERTAIN OTHER INDIVIDUALS HAVE BEEN CONVICTED OF CERTAIN OFFENSES

SEC. 1033. Section 1866(b)(2)(G) of the Social Security Act (42 U.S.C. 1395cc(b)(2)(G)) is amended by inserting ", or that any person who has a direct or indirect ownership or control interest of 5 percent or more in such provider, or who is an officer, director, agent, or managing employee (as defined in section 1126(b)) of such provider, is a person described in section 1126(a)(2)" after "1126(a)".

ELIMINATION OF HEALTH INSURANCE BENEFITS ADVISORY COUNCIL

SEC. 1034. (a) Section 1867 of the Social Security Act (42 U.S.C. 1395dd) is repealed.

(b)(1) The first sentence of section 1863 of such Act (42 U.S.C. 1395z) is amended by striking out "the Health Insurance Benefits Advisory Council established by section 1867, appropriate State agencies" and inserting in lieu thereof "appropriate State agencies".

(2) The first sentence of section 7(d)(4) of the Railroad Retirement Act of 1974 (45 U.S.C. 231f(d)(4)) is amended by striking out "1867,".

(3) Section 361 of the Social Security Amendments of 1977 (42 U.S.C. 907a) is amended by striking out subsection (i).

OPEN ENROLLMENT PERIODS FOR HEALTH MAINTENANCE ORGANIZATIONS AND COMPETITIVE MEDICAL PLANS

SEC. 1035. (a) Subsection (c)(3)(A) of section 1876 of the Social Security Act (42 U.S.C. 1395mm) is amended—

(1) by inserting "(i)" after "(3)(A)",

(2) by inserting "and including the 30-day period specified under clause (ii)" after "30 days duration every year", and

(3) by adding at the end the following new clause:

"(ii) For each area served by more than one eligible organization under this section, the Secretary (after consultation with such organizations) shall establish a single 30-day period each year during which all eligible organizations serving the area must provide for open enrollment under this section. The Secretary shall determine annual per capita rates under subsection (a)(1)(A) in a manner that assures that individuals enrolling during such a 30-day period will not have premium charges increased or any additional benefits decreased during the 12-month enrollment period for which the individual is enrolling. An eligible organization may provide for such other open enrollment period or periods as it deems appropriate consistent with this section.".

(b) The Secretary of Health and Human Services may phase in, over a period of not longer than three years, the application of the amendments made by subsection (a) to all applicable areas in the United States if the Secretary determines that it is not administratively feasible to establish a single 30-day open enrollment period for all such applicable areas before the end of the period.

DEADLINE FOR REPORT ON INCLUDING PAYMENT FOR PHYSICIANS' SERVICES TO HOSPITAL INPATIENTS IN DRG PAYMENT AMOUNTS

SEC. 1036. The second sentence of section 603(a)(2)(B) of the Social Security Amendments of 1983 (Public Law 98–21) is amended by striking out "include, in a report to Congress in 1985," and inserting in lieu thereof "submit to Congress, not later than July 1, 1985, a report to Congress which includes".

FLEXIBLE SANCTIONS FOR NONCOMPLIANCE WITH REQUIREMENTS FOR END-STAGE RENAL DISEASE FACILITIES

SEC. 1037. Section 1881(c)(3) of the Social Security Act (42 U.S.C. 1395rr(c)(3)) is amended by adding at the end the following new sentence: "Where the Secretary also determines that the facility's or provider's failure to cooperate with the Secretary's plans and goals does not jeopardize patient health or safety or justify termination of certification, the Secretary may, instead of terminating or withholding certification and after reasonable notice to the provider or facility and to the public, impose such other sanctions as may be appropriate, which sanctions may include denial of reimbursement with respect to some or all patients admitted to the facility after the date of the notice and graduated reduction in reimbursement for all patients.".

REMOVING COSTS OF NURSE ANESTHETISTS FROM DRG-BASED PAYMENTS

SEC. 1038. (a) The second sentence of section 1886(a)(4) of the Social Security Act (42 U.S.C. 1395ww(a)(4)) is amended by inserting "and costs related to employment or contracts for the professional services of certified registered nurse anesthetists" after "capital-related costs".

(b) The second sentence of section 603(a)(2)(B) of the Social Security Amendments of 1983 (Public Law 98-21) is amended by inserting "and for services of certified registered nurse anesthetists" after "physicians' services".

(c) The amendment made by subsection (a) shall apply to payments for cost reporting periods beginning on or after October 1, 1984, and before October 1, 1986.

DETERMINATION OF HOSPITAL AREA WAGE INDEX

SEC. 1039. (a) Section 1886(d)(3)(E) of the Social Security Act (42 U.S.C. 1395ww(d)(3)(E)) is amended by adding at the end the following new sentence: "The Secretary shall establish criteria under which, in the case of a hospital that demonstrates to the Secretary in a current fiscal year that the adjustment being made under the previous sentence (or under paragraph (2)(H)) for that hospital's discharges in that fiscal year does not accurately reflect the wage levels in the labor market serving the hospital, the Secretary, to the extent he deems appropriate, shall modify such adjustment for that hospital for discharges in the subsequent fiscal year to take into account a difference in payment amounts in that current fiscal year to the hospital that resulted from such inaccuracy.".

(b) The Secretary of Health and Human Services shall develop, in consultation with the Secretary of Labor and the Commissioner of the Bureau of Labor Statistics, methods of refining and improving the adequacy and equity of the area wage indices used under paragraphs (2)(H) and (3)(E) of section 1886(d) of the Social Security Act. The Secretary shall report to Congress on such developments not later than June 1, 1984.

DEFINITION OF BONA FIDE EMERGENCY SERVICES FOR PURPOSES OF LIMITATIONS ON PAYMENT FOR HOSPITAL OUTPATIENT SERVICES

SEC. 1040. In the administration of section 1861(v)(1)(K) of the Social Security Act (42 U.S.C. 1395x(v)(1)(K)), the Secretary of Health and Human Services shall provide that "bona fide emergency services" shall include services provided in a hospital emergency room after the onset of a medical condition manifesting itself by symptoms of sufficient severity that the absence of immediate medical attention could reasonably be expected, by a prudent layperson possessing an average knowledge of health and medicine, to result in—

(1) placing the patient's health in jeopardy,

(2) serious impairment to bodily functions,

(3) serious dysfunction of any bodily organ or part,

(4) development or continuance of severe pain.

DELAY OF EFFECTIVE DATE FOR SINGLE-RATE FOR SKILLED NURSING FACILITIES

SEC. 1041. Effective September 30, 1983, section 102(b) of the Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97–248), as amended by section 605 of the Social Security Amendments of 1983 (Public Law 98–21), is amended by striking out "October 1, 1983" and inserting in lieu thereof "April 1, 1984".

TITLE XI—TRADE ADJUSTMENT ASSISTANCE

SEC. 1101. LIMITATIONS ON TRADE READJUSTMENT ALLOWANCES.

The first sentence of section 233(a)(3) of the Trade Act of 1974 (19 U.S.C. 2293(a)(3)) is amended to read as follows: "Notwithstanding paragraph (1), in order to assist the adversely affected worker to complete training approved for him under section 236, and in accordance with regulations prescribed by the Secretary, payments may be made as trade readjustment allowances for up to 26 additional weeks in the 26-week period that—

"(A) follows the last week of entitlement to trade readjustment allowances otherwise payable under this chapter; or

"(B) begins with the first week of such training, if such training is approved after the last week described in subparagraph (A).".

SEC. 1102. JOB SEARCH AND RELOCATION ALLOWANCES.

(a) Section 237(a)(1) of the Trade Act of 1974 (19 U.S.C. 2297(a)(1)) is amended by striking out "$600" and inserting in lieu thereof "$800".

(b) Section 238(d)(2) of the Trade Act of 1974 (19 U.S.C. 2298(d)(2)) is amended by striking out "$600" and inserting in lieu thereof "$800".

SEC. 1103. ASSISTANCE TO INDUSTRY.

Section 265 of the Trade Act of 1974 (19 U.S.C. 2355) is amended—

(1) by amending subsection (a)—

(A) by inserting "or workers" immediately after "substantial number of firms", and

(B) by inserting "223 or" immediately before "251"; and

(2) by striking out "$2,000,000" in subsection (b) and inserting in lieu thereof "$10,000,000".

TITLE XII—HIGHWAY REVENUE PROVISIONS

SEC. 1200. TABLE OF CONTENTS.

Sec. 1200. Table of contents.
Sec. 1201. Reduction of heavy vehicle use tax.
Sec. 1202. Increase in diesel fuel tax.
Sec. 1203. Study.

SEC. 1201. REDUCTION OF HEAVY VEHICLE USE TAX.

(a) General Rule.—Subsection (a) of section 4481 (as amended by section 513(a) of the Highway Revenue Act of 1982) is amended to read as follows:

"(a) Imposition of Tax.—A tax is hereby imposed on the use of any highway motor vehicle which (together with the semitrailers and trailers customarily used in connection with highway motor vehicles of the same type as such highway motor vehicle) has a taxable gross weight of at least 55,000 pounds at the rate specified in the following table:

"Taxable gross weight:	Rate of tax:
"At least 55,000 pounds, but not over 72,000 pounds	$150 per year plus $20 for each 1,000 pounds (or fraction thereof) in excess of 55,000 pounds.
Over 72,000 pounds	$500."

(b) SPECIAL RULES IN THE CASE OF CERTAIN OWNER-OPERATORS.—

(1) SPECIAL RULE FOR TAXABLE PERIOD BEGINNING ON JULY 1, 1984.—In the case of a small owner-operator, the amount of the tax imposed by section 4481 of the Internal Revenue Code of 1954 on the use of any highway motor vehicle subject to tax under section 4481(a) of such Code (as amended by subsection (a)) for the taxable period which begins on July 1, 1984, shall be the lesser of—

(A) $3 for each 1,000 pounds of taxable gross weight (or fraction thereof), or

(B) the amount of the tax which would be imposed under such section 4481(a) without regard to this paragraph.

(2) EXEMPTION FOR VEHICLES USED FOR LESS THAN 5,000 MILES (AND CERTAIN OTHER AMENDMENTS) TO TAKE EFFECT ON JULY 1, 1984.—In the

case of a small owner-operator, notwithstanding subsection (f)(2) of section 513 of the Highway Revenue Act of 1982, the amendments made by subsections (b), (c), and (d) of such section shall take effect on July 1, 1984.

(3) SMALL OWNER-OPERATOR DEFINED.—For purposes of this subsection, the term "small owner-operator" has the meaning given such term by section 513(f)(2) of the Highway Revenue Act of 1982.

(4) TAXABLE GROSS WEIGHT.—For purposes of this subsection, the term 'taxable gross weight' has the same meaning as when used in section 4481 of the Internal Revenue Code of 1954.

(c) EFFECTIVE DATE.—The amendment made by subsection (a) (and the provisions of subsection (b)) shall take effect on July 1, 1984.

SEC. 1202. INCREASE IN DIESEL FUEL TAX.

(a) GENERAL RULE.—Paragraph (1) of section 4041(a) (relating to diesel fuel) is amended by striking out "9 cents" and inserting in lieu thereof "14½ cents".

(b) TREATMENT OF GASOHOL.—Paragraph (1) of section 4041(k) (relating to fuels containing alcohol) is amended to read as follows:

"(1) IN GENERAL.—Under regulations prescribed by the Secretary, in the case of the sale or use of any liquid at least 10 percent of which consists of alcohol (as defined in section 4081(c)(3))—

"(A) subsection (a)(1) shall be applied by substituting '9½ cents' for '14½ cents', and

"(B) subsection (a)(2) shall be applied by substituting '4 cents' for '9 cents', and

"(C) no tax shall be imposed by subsection (c)."

(c) INCOME TAX CREDIT FOR PURCHASE OF DIESEL POWERED AUTOMOBILE OR LIGHT TRUCK.—Section 6427 (relating to fuels not used for taxable purposes), as amended by this Act, is amended by redesignating subsections (g), (h), (i), (j), (k), (l), and (m) and as subsections (h), (i), (j), (k), (l), (m), and (n), respectively, and by inserting after subsection (f) the following new subsection:

"(g) ADVANCE REPAYMENT OF INCREASED DIESEL FUEL TAX TO ORIGINAL PURCHASERS OF DIESEL-POWERED AUTOMOBILES AND LIGHT TRUCKS.—

"(1) IN GENERAL.—Except as provided in subsection (j), the Secretary shall pay (without interest) to the original purchaser of any qualified diesel-powered highway vehicle an amount equal to the diesel fuel differential amount.

"(2) QUALIFIED DIESEL-POWERED HIGHWAY VEHICLE.—For purposes of this subsection, the term 'qualified diesel-powered highway vehicle' means any diesel-powered highway vehicle which—

"(A) has at least 4 wheels,

"(B) has a gross vehicle weight rating of 10,000 pounds or less, and

"(C) is registered for highway use in the United States under the laws of any State.

"(3) DIESEL FUEL DIFFERENTIAL AMOUNT.—For purposes of this subsection, the term 'diesel fuel differential amount' means—

"(A) except as provided in subparagraph (B), $96, or

"(B) in the case of a truck or van, $180.

"(4) ORIGINAL PURCHASER.—For purposes of this subsection—

(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'original purchaser' means the first person to purchase the qualified diesel-powered vehicle for use other than resale.

"(B) EXCEPTION FOR CERTAIN PERSONS NOT SUBJECT TO FUELS TAX.—The term 'original purchaser' shall not include any State or local government (as defined in section 4221(d)(4)) or any nonprofit educational organization (as defined in section 4221(d)(5)).

"(C) TREATMENT OF DEMONSTRATION USE BY DEALER.—For purposes of subparagraph (A), use as a demonstrator by a dealer shall not be taken into account.

"(5) VEHICLES TO WHICH SUBSECTION APPLIES.—Except as provided in paragraph (6), this subsection shall only apply to qualified diesel-powered highway vehicles originally purchased after January 1, 1985, and before January 1, 1988.

"(6) SPECIAL RULE FOR CERTAIN VEHICLES HELD ON JANUARY 1, 1985.—

"(A) IN GENERAL.—In the case of any person holding a qualified diesel-powered highway vehicle on January 1, 1985—

"(i) such person shall be treated as if he originally purchased such vehicle on December 31, 1984, but

"(ii) the amount payable under paragraph (1) to such person for such vehicle shall be the applicable fraction of the diesel fuel differential amount.

"(B) APPLICABLE FRACTION.—For purposes of subparagraph (A), the applicable fraction is the fraction determined in accordance with the following table:

"If the model year of the vehicle is:	The applicable percentage is:
1984 or 1985	1
1983	⅚
1982	⅘
1981	⅗
1980	⅖
1979	⅙

In the case of a 1978 or earlier model year vehicle, the applicable fraction shall be zero.

"(7) BASIS REDUCTION.—

"(A) IN GENERAL.—For purposes of subtitle A, the basis of any qualified diesel-powered highway vehicle shall be reduced by the amount payable under this subsection with respect to such vehicle.

"(B) COORDINATION WITH LIMITATION ON LUXURY AUTOMOBILES.—The limitation of section 168(d)(3)(A) with respect to any vehicle shall be reduced by the amount payable under paragraph (1) with respect to such vehicle."

(d) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) AMENDMENTS TO HIGHWAY TRUST FUND.—

(A) TRANSFERS TO MASS TRANSIT ACCOUNT.—Paragraph (2) of section 9503(e) (relating to transfers to Mass Transit Account) is amended to read as follows:

"(2) TRANSFERS TO MASS TRANSIT ACCOUNT.—The Secretary of the Treasury shall transfer to the

Mass Transit Account the mass transit portion of the amounts appropriated to the Highway Trust Fund under subsection (b) which are attributable to taxes under sections 4041 and 4081 imposed after March 31, 1983. For purposes of the preceding sentence, the term 'mass transit portion' means an amount determined at the rate of 1 cent for each gallon with respect to which tax was imposed under section 4041 or 4081."

(B) INCOME TAX CREDITS PAYABLE OUT OF HIGHWAY TRUST FUND.—Clause (ii) of section 9503(c)(2)(A) is amended by striking out "used before October 1, 1988" and inserting in lieu thereof "used before October 1, 1988 (or with respect to qualified diesel-powered highway vehicles purchased before January 1, 1988)".

(2) CONFORMING AMENDMENTS TO INCOME TAX CREDIT.—

(A) Subsections (a)(4) and (b) of section 39 (as in effect before the enactment made by title IV of this Act) are each amended by striking out "6427(i)" and inserting in lieu thereof "6427(j)".

(B) Subsections (a), (b)(1), (c), (d), (e)(1), and (f)(1) of section 6427 are each amended by striking out "(i)" and inserting in lieu thereof "(j)".

(C) Subsection (h)(1) of section 6427 (as redesignated by subsection (c)) is amended—

(i) by striking out "or (f)" and inserting in lieu thereof "(f), or (g)", and

(ii) by striking out "fuel used" each place it appears and inserting in lieu thereof "fuel used (or a qualified diesel powered highway vehicle purchased)".

(D) Subsection (h)(2)(A) of section 6427 (as so redesignated) is amended—

(i) by striking out "and (e)" in clause (i) and inserting in lieu thereof "(e), and (g)", and

(ii) by striking out "fuel used" each place it appears and inserting in lieu thereof "fuel used (or a qualified diesel powered highway vehicle purchased)".

(E) Subsection (k)(2) of section 6427 (as so redesignated) is amended by striking out "(g)(2)" and inserting in lieu thereof "(h)(2)".

(F) Subsection (m) of section 6427 (as so redesignated) is amended by striking out "and (d)" each place it appears and inserting in lieu thereof "(d), and (g)".

(G) Sections 7210, 7603, 7604(b), 7604(c)(2), 7605(a), 7609(c)(1), and 7610(c) are each amended by striking out "6427(h)(2)" each place it appears and inserting in lieu thereof "6427(i)(2)".

(e) EFFECTIVE DATE.—The amendments made by this section shall take effect on July 1, 1984.

SEC. 1203. STUDY.

(a) GENERAL RULE.—The Secretary of Transportation (in consultation with the Secretary of the Treasury) shall conduct a study of whether highway motor vehicles with taxable gross weights of 80,000 pounds or more bear their fair share of the costs of the highway system.

(b) REPORT.—Not later than the day 1 year after the date of the enactment of this Act, the Secretary of Transportation shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on the study conducted under subsection (a) together with such recommendations as he may deem advisable.

I. LEGISLATIVE BACKGROUND

Sources of the bill

On March 1, 1984, the Committee on Ways and Means adopted a committee amendment to H.R. 4170 to be offered as a substitute for the previously reported bill. The committee amendment to H.R. 4170 consists of 12 titles. These 12 titles are either from bills previously ordered favorably reported by the committee or certain other provisions ordered favorably reported. Markup by the full committee on these provisions occurred on July 26-27, October 4-6, and October 18-19, 1983, with H.R. 4170 being ordered favorably reported on October 20, 1983, and a committee report filed on October 21, 1983 (H. Rept. No. 98-432), Subcommittee markup dates are indicated below:

The sources of the 12 titles of the committee amendment to H.R. 4170 are as follows:

Title I—Tax Freeze and Tax Reform Generally including Tax-Exempt Entity Leasing Provisions.[1]

Title II—Life Insurance Tax Provisions (H.R. 4065, as amended).

Title III—Revision of Private Foundation Provisions (report and recommendations of the Oversight Subcommittee, with amendments).

Title IV—Tax Simplification Provisions (H.R. 3475, as amended, including H.R. 3592 and H.R. 3593, as amended).

Title V—Fringe Benefit Provisions (H.R. 3525, as amended).

Title VI—Technical Corrections (H.R. 3805, as amended).

Title VII—Tax-Exempt Bond Provisions (including H.R. 2504, as amended).

Title VIII—Miscellaneous Revenue Matters (H.R. 699, H.R. 2476, H.R. 2831, H.R. 3096, and H.R. 3173, as amended, plus additional miscellaneous provisions adopted on November 16, 1983 and February 29 and March 1, 1984).

Title IX—Social Security Disability Benefits (H.R. 3755, as amended).

Title X—Medicare Budget Reconciliation Amendments (recommendations from the Subcommittee on Health, as amended).

Title XI—Trade Adjustment Assistance (certain provisions from (H.R. 3391, as previously reported by the committee and passed by the House).

Title XII—Highway Use and Diesel Fuel Tax changes (adopted in committee markup on March 1, 1984).

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[1] The Tax-exempt entity leasing provisions were in title I of H.R. 4170 as reported, and originally were from H.R. 3110, with amendments. The tax freeze provisions, with amendments, are from Mr. Rostenkowski's proposed floor amendment to H.R. 4170 (printed in the Congressional Record, November 16, 1983). The other tax reform provisions of title I are as a result of committee hearings on February 22 and 28, 1984, on the Treasury Department's proposed tax shelter and other tax reform provisions and related tax provisions considered by the committee.

Committee and subcommittee consideration of H.R. 4170 and committee amendment to H.R. 4170.

Title I—Tax Freeze and Tax Reform Generally (including Tax-Exempt Entity Leasing Provisions)

The tax-exempt entity leasing provisions originated from H.R. 3110 as amended and ordered favorably reported by the committee on July 27, 1983. The bill was introduced on My 24, 1983, and the committee held a public hearing on June 8, 1983. The provisions of H.R. 3110 were marked up by the committee on July 26 and 27, 1983.

The tax freeze provisions originated with modifications from a proposed floor amendment to H.R. 4170 by Mr. Rostenkowski (printed in the November 16, 1983 *Congressional Record*). The tax reform provisions of title I are from public hearings on February 22 and 28, 1984, on the Treasury Department's proposed tax shelter and other tax reform proposals, and other committee amendments adopted in markup on February 29 and March 1, 1984.

Title II—Life Insurance Tax Provisions

This title originated from H.R. 4065 as amended and ordered favorably reported by the committee on October 5, 1983. The bill was introduced on October 3, 1983, as ordered reported from the Subcommittee on Select Revenue Measures. Subcommittee markup sessions were held on a draft proposal on August 2, 1983 and September 27, 1983. Subcommittee hearings on life insurance tax proposals were held on May 10–11, 1983 and July 28, 1983.

This title was further amended by the committee in markup on February 29 and March 1, 1984.

Title III-Revision of Private Foundation Provisions

This title originated from a report and recommendations of the Subcommittee on Oversight. (See Subcommittee Report dated September 28, 1983, WMCP 98–14.) The committee marked up the Subcommittee recommendations on October 5 and 6, 1983. The Subcommittee approved its recommendations on September 14 and 15, 1983. Subcommittee hearings on the tax treatment of private foundations were held on June 27, 28, and 30, and 1983.

This title was further amended by the committee in markup on February 29 and March 1, 1984.

Title IV—Tax Simplification provisions

This title originated from H.R. 3475 as amended and ordered favorably reported by the committee on October 4, 1983. H.R. 3475 was introduced on June 30, 1983, and the committee held a public hearing on July 25, 1983.

The title also includes the provisions of H.R. 3592 and H.R. 3593 as ordered favorably reported by the committee on October 4, 1983. A public hearing was held on these bills on September 21, 1983, by the Subcommittee on Select Revenue Measures. The Subcommittee marked up and approved these bills on September 29, 1983.

This title was further amended by the committee in markup on February 29 and March 1, 1984.

Title V—Fringe Benefit Provisions

This title originated from H.R. 3525 as amended and ordered favorably reported by the committee on October 5, 1983. The bill was introduced on July 12, 1983, and a public hearing was held on August 1, 1983, by the Subcommittee on Select Revenue Measures. The Subcommittee marked up and approved the bill on September 29, 1983.

This title was further amended by the committee in markup on February 29 and March 1, 1984.

Title VI—Technical Corrections

This title originated from H.R. 3805 as amended and ordered favorably reported by the Committee on October 4, 1983. This bill was introduced on August 4, 1983, and the committee held a public hearing on September 22, 1983.

This title was further amended by the Committee in markup on February 29 and March 1, 1984.

Title VII—Tax-Exempt Bond Provisions

This title was based generally on the provisions of H.R. 1635 and H.R. 1176, and these provisions as amended were approved and ordered favorably reported by the committee on October 18, 1983. H.R. 1635 was introduced on February 24, 1983, and a public hearing was held by the committee on June 15–16, 1983. H.R. 1176 was introduced on February 2, 1983, and a public hearing was held by the committee on June 15–16, 1983.

The title also includes the provisions of H.R. 2504 as amended and ordered favorably by the committee on October 4, 1983. H.R. 2504 was introduced on April 12, 1983, and a public hearing was held on September 21, 1983, by the Subcommittee on Select Revenue Measures. The Subcommittee marked up the bill and approved it on September 29, 1983.

This title was further amended by the committee in markup on November 16, 1983, and on February 29 and March 1, 1984.

Title VIII—Miscellaneous Revenue Matters

This title originated in H.R. 4170 from five miscellaneous tax bills (H.R. 699, H.R. 2476, H.R. 2831, H.R. 3096, and H.R. 3173) as amended and ordered favorably reported by the committee on October 4, 1983. These bills were marked up and approved on September 29, 1983, by the Subcommittee on Select Revenue Measures. A public hearing was held by the Subcommittee on September 21, 1983. H.R. 699 was introduced on January 6, 1983; H.R. 2476 was introduced on April 12, 1983; H.R. 2831 was introduced on April 28, 1983; H.R. 3096 was introduced on May 23, 1983; and H.R. 3173 was introduced on May 26, 1983.

Additional miscellaneous committee amendments were adopted in committee markup on November 16, 1983, and on February 29 and March 1, 1984.

Title IX—Social Security Disability Benefits

This title originated from H.R. 3755 as amended and ordered favorably reported by the committee on September 27, 1983. The bill was introduced on August 3, 1983, and the Subcommittee on Social Security marked up and approved the bill on August 3, 1983. A public hearing was held on the subject by the Subcommittee on June 30, 1983.

This title was further amended by the committee in markup on February 29, 1984.

Title X—Medicare Budget Reconciliation Amendments

This title originated from provisions as amended and ordered favorably reported by the committee on October 19, 1983. The provisions considered by the committee were from recommendations by the Subcommittee on Health, which marked up and approved the recommendations on October 5, 1983.

This title was further amended by the committee in markup on November 16, 1983, and on February 29 and March 1, 1984.

Title XI—Trade Adjustment Assistance Programs

This title originated from sections 3, 6, and 8 of H.R. 3391 as previously reported by the committee on June 29, 1983 (H. Rep. No. 98-281), and passed by the House on September 15, 1983. A Subcommittee hearing was held on the subject on February 15, 1983.

Title XII—Highway Use and Diesel Fuel Tax Changes

This title was added by the committee in markup on March 1, 1984, after a public hearing on the subject on February 23, 1984.

II. SUMMARY

Title I.—Tax Freeze; Tax Reforms Generally

A. "Tax Freeze" and Related Provisions

1. Foreign earned income

Under present law, the maximum amount of income earned abroad excluded from taxable income is $80,000 for 1983, and is scheduled to increase in $5,000 annual increments to a permanent level of $95,000 in 1986. The bill freezes the amount of the exclusion at $80,000 until 1988 and increases it in $5,000 increments to $95,000 in 1990.

2. Expensing of business personal property

Under present law, the amount of personal property which businesses may elect to expense each year is scheduled to increase from $5,000 in 1983 to $7,500 in 1984 and 1985 and to $10,000 thereafter. The bill freezes the maximum amount that can be expensed at $5,000 through 1987, increasing it to $7,500 in 1988 and 1989 and $10,000 thereafter.

3. Investment credit for used property

Under present law, the maximum amount of used property eligible for the investment credit is scheduled to increase from $125,000 to $150,000 in 1985. The bill freezes the amount eligible for the credit at $125,000 through 1987, after which this limit increases to $150,000.

4. Net interest exclusion

Under present law, starting in 1985, individuals will be able to exclude 15 percent of interest income to the extent such income exceeds certain interest deductions, up to a maximum exclusion of $450 for single persons and $900 for married couples. The bill repeals this net interest exclusion.

5. Limits on pension plans

Under present law, the dollar limits on the contributions to and benefits from tax-qualified pension plans are scheduled to be indexed for inflation in 1986. The bill freezes the dollar limits at current levels until 1988. After 1988, the limits will be indexed.

6. Employee stock ownership plans

Under present law, the limit on the tax credit for employer contributions to an employee stock ownership plan (ESOP) is scheduled to increase from one-half of one percent of payroll in 1983 and 1984 to three-fourths of one percent in 1985. The bill freezes the limit at the current rate through 1987.

7. Estate and gift tax rate

Under present law, the maximum estate and gift tax rate is scheduled to be reduced from 60 percent in 1983 to 55 percent in 1984 and 50 percent in subsequent years. The bill freezes the rate at 60 percent until 1988 and reduces the rate to 55 percent in 1988 and 50 percent thereafter.

8. Windfall profit tax on newly discovered oil

Under present law, the windfall profit tax rate on newly discovered oil is scheduled to decline from 25 percent in 1983 to 22.5 percent in 1984, 20 percent in 1985, and 15 percent in 1986 and subsequent years. The bill freezes the rate at 25 percent through 1987, and reduces the rate to 22.5 percent for 1988, 20 percent for 1989 and 15 percent for 1990 and future years.

9. Percentage depletion on secondary and tertiary production

Under present law, the allowance for percentage depletion on secondary and tertiary oil production expired at the end of 1983. The bill corrects the technical error leading to this termination and clarifies that percentage depletion will not be available after 1983 for secondary or tertiary production from proven properties transferred after 1974.

10. Cigarette excise tax

Under present law, the 16-cents-per-pack excise tax on cigarettes is scheduled to be reduced to 8 cents on October 1, 1985. The bill reduces the tax only from 16 cents per pack to 12 cents, for the period October 1, 1985, through December 31, 1987.

11. Excise tax on distilled spirits

Under present law, the excise tax on distilled spirits is $10.50 per proof gallon. The bill increases the tax to $14.25 per proof gallon for the period October 1, 1985, through December 31, 1987.

12. Telephone excise tax

Under present law, the 3-percent telephone excise tax is scheduled to expire after 1985. Under the bill, the 3-percent tax remains in effect through 1987.

13. Finance leasing

Under present law, liberalized leasing rules for limited use property and fixed price purchase options become effective on January 1, 1984. The bill postpones that effective date for four years. Present liberalized leasing rules are continued for up to $150,000 of farm equipment. In addition, general transition rules are provided.

14. Leasing regulations

The Treasury is prohibited from issuing regulations distinguishing leases from conditional sales agreements or other financing arrangements. The prohibition, which expires December 31, 1987, does not apply with respect to certain arrangements involving motor vehicles.

B. Tax-Exempt Entity Leasing

Present law

The Federal income tax benefits of ownership of property generally include accelerated depreciation deductions and investment tax credits. Essentially, the law is that the economic substance of a transaction, not its form, determines who is entitled to the tax benefits associated with ownership. Thus, in a lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

The tax benefits of ownership are generally allowed only for property used for a business or income-producing purpose. They are not available for property that is owned by governmental units and tax-exempt organizations. Property that is used (though not owned) by a tax-exempt organization or a domestic governmental unit qualifies for accelerated cost recovery (ACRS) or other depreciation deductions but generally does not qualify for investment credits (nontaxable use restriction). For example, property used under a lease by one of those entities is ineligible for the investment credit. A statutory exception to the nontaxable use restriction provides that qualified rehabilitation expenditures for a building leased to a tax-exempt organization or a governmental unit can qualify for the rehabilitation tax credit. Also, one court has held, and the Internal Revenue Service (IRS) has ruled, that investment credits can be claimed where a governmental unit essentially contracts not for the use of property itself, but rather for a service to be provided by the owner of the property.

Property used by a foreign government or person is not subject to the nontaxable use restriction. However, if the property is used predominantly outside the United States, then, in general, ACRS deductions are slowed down and no investment credit is allowed.

The bill

In general, the bill reduces the tax benefits available for certain property that is leased to or otherwise used by tax-exempt entities. Under the bill, tax-exempt entities include the United States, any State or local governmental unit, possessions of the United States, and most agencies and instrumentalities of any of the foregoing. The term also includes organizations (other than farmers' cooperatives described in Code section 521) exempt from United States income tax and certain organizations that were formerly exempt. The term also includes certain foreign persons or entities.

The bill generally requires that ACRS or other depreciation deductions for property used by tax-exempt entities be computed using the straight-line method over a recovery period equal to the greater of the present class life of the property under the Asset Depreciation Range (ADR) system (40 years in the case of 15-year real property) or, in the case of property subject to a lease, 100 percent (125 percent in the case of 15-year real property) of the term of the lease. In the case of 15-year real property, this provision applies to the extent of use of a type or types specified in the bill, but only if more than 20 percent of the property is so used. Special depreciation rules are provided for certain high technology property which is tangible personal property.

The bill also provides criteria for determining whether a transaction that is structured as a service contract or other arrangement (including a partnership or other pass-through entity) should be treated as a lease for purposes of the depreciation and investment credit provisions of the bill. The rehabilitation credit will be denied for real property that is subject to the slower depreciation rules provided by the bill, but only if the rehabilitation expenditures are, or acquisition of the building to be rehabilitated is, financed in whole or in part with the proceeds of obligations the interest on which is exempt from Federal income tax under section 103(a).

The depreciation provisions of the bill do not apply to property leased for a short term, as defined in the bill.

The bill generally applies to property placed in service by the taxpayer after May 23, 1983, and to property used under an agreement entered into after that date. However, transitional rules are provided.

C. Treatment of Bonds and Other Debt Instruments

1. Debt obligations acquired at a discount

a. Market discount

Under present law, upon the disposition of a market-discount bond issued by a corporation or a governmental unit and held for more than one year, capital gain treatment is accorded to the appreciation in value attributable to market discount. When a taxpayer borrows the funds used to purchase a market-discount bond, interest on the acquisition indebtedness generally can be deducted currently against ordinary income. Thus, a taxpayer who leverages the purchase of a market-discount bond effectively converts ordinary income to capital gain.

The bill generally requires that gain on disposition of a market discount bond be recognized as interest income, to the extent of accrued market discount. This provision is effective for bonds issued after the date of enactment.

The bill also limits a taxpayer's ability to take current interest deductions on indebtedness incurred to purchase or carry a market discount bond. This change is effective for bonds acquired after the date of enactment.

The bill provides an election to include accrued market discount in income currently. Neither the rule requiring ordinary income treatment on disposition nor the rule limiting interest deductions will apply to bonds with respect to which the election is made.

b. Original issue discount on tax-exempt bonds

Under the Code, original issue discount (OID) on noninterest-bearing obligations issued by a State or local government is exempt from tax. Under Internal Revenue Service rulings, tax-exempt OID is apportioned on a straight-line basis among the original holder and subsequent purchasers of a bond. The application of this rule permits the holder of a deep discount municipal bond to generate an artificial loss by disposing of the bond prior to maturity.

The bill requires the holders of tax-exempt obligations to accrue tax-exempt OID by using the constant interest method provided by present law for the holders of obligations issued by corporations and other entities. Under the bill, the basis of an obligation is increased by the amount of accrued tax-exempt OID. Thus, the holder of a zero coupon municipal bond will be able to claim economic losses realized on disposition of the bond. These changes apply to bonds issued after September 3, 1982, and acquired after March 1, 1984.

c. Discount on short-term obligations

For governmental obligations (Treasury bills) issued at a discount and payable without interest at a fixed maturity not exceeding one year, the acquisition discount is not considered under present law to accrue until the obligation is paid at maturity or otherwise disposed of. A similar rule applies with respect to original issue discount of cash-basis taxpayers who hold other obligations with a maturity of one year or less (e.g., bank certificates of deposit). Taxpayers who make leveraged purchases of obligations eligible for the special rules are able to defer tax liability on unrelated income.

The bill limits the scope of the special rules permitting deferral of acquisition and original issue discount on short-term obligations. Accrual basis taxpayers and those cash basis taxpayers who acquire Treasury bills and short-term original discount obligations in the course of a trade or business will be required to account for the acquisition or original issue discount on the accrual basis. Taxpayers will treat this change as a change of accounting method and space the payment of any net tax liability over 10 years. In addition the bill limits the ability to use leveraged purchases of short-term obligations within the special rules to defer tax on ordinary income by deferring the deductions for interest on indebtedness used to purchase or carry short-term discount obligations. An election is provided under which taxpayers who remain eligible for the special rules can avoid application of the interest deferral rule by electing to include acquisition and original issue discount in income as it accrues.

This provision will be effective for obligations acquired after the date of enactment.

2. Deferred payment transactions

a. Time for inclusion or deduction of deferred interest

Present law provides that, in general, in a discount lending transaction, the borrower is treated as having paid, and the lender as having received, the annual unpaid interest, which is then relent to the borrower. These original issue discount (OID) rules match the interest inclusion by the lender with the interest deduction by the borrower. The OID rules of present law do not apply to obligations issued in exchange for property where neither the obligation nor the property is publicly traded; to obligations issued by individuals; as to holders of discount obligations, to obligations not held as capital assets; or to deferred payments for services or use of property.

The bill extends the OID rules to obligations issued for nontraded property, issued for services or use of property, issued by individuals, and not held as capital assets. The interest element in obligations issued for nontraded property, services, or use of property is to be compared to a test rate. The test (safe harbor) rate is 110 percent of an average yield on Federal obligations of similar maturity (the "applicable Federal rate"). This yield is to be redetermined semi-annually for 3 categories of maturities (short-, medium- and long-term). If interest is not paid annually at least at this rate (or if interest stated at a higher rate is not paid at least at that rate), interest is to be imputed at a rate equal to 120 percent of the applicable Federal rate (or at the higher stated rate) and annually included in the income of the lender and deducted by the borrower. Exceptions to these rules are provided for sales of principal residences, certain sales of farms, and sales involving total payments of $250,000 or less. These provisions generally apply to transactions entered into after December 31, 1984, except for sales or exchanges with respect to which there was a binding commitment on March 1, 1984.

Foreign investors acquiring pure original issue discount corporate bonds—those with no payment of interest until maturity—defer U.S. taxation until they surrender the bonds at maturity. The rules governing timing of income inclusion for foreign investors holding corporate OID debt differ in some respects from those governing income inclusion for U.S. investors. As for foreign holders of debt originally issued at a discount by obligors other than corporations and governmental entities, existing law is unclear.

The bill conforms the timing of income inclusions for foreign investors to the timing for comparable U.S. investors, except that there is no inclusion for foreign investors until actual receipt of payment. The bill also conforms the treatment of noncorporate debt to the treatment of corporate debt. These provisions generally apply to payments made on or after the 60th day after the date of enactment.

The Internal Revenue Code does not contain specific rules governing foreign investors who sell or surrender stripped bonds or who sell stripped coupons. The bill generally conforms the rules governing foreign investors to those governing U.S. investors, except that there is no inclusion for foreign investors until actual receipt of payment. Thus, foreign investors will treat stripped coupons and stripped bonds as being OID instruments. These provisions will apply generally to payments made on or after the 60th day after enactment.

b. Measurement of interest in deferred payment transactions

Under present law, if the parties to a deferred payment sale fail to state interest at a safe-harbor rate fixed by regulation, interest is imputed at a higher rate fixed by regulation. The safe-harbor rate is a simple interest rate; the imputed rate is a compound rate. Imputed interest is allocated among deferred payments in proportion to the amount of the payment, without regard to the period of time that has elapsed since the sale.

The bill provides that the adequacy of the interest element in a deferred payment sale is to be tested against a self-adjusting compound rate of interest which approximates a market rate. This test (safe-harbor) rate is the same rate applied under the proposed amendments to the OID rules: 110 percent of the applicable Federal rate. If insufficient interest is stated, interest is to be imputed at a rate equal to 120 percent of the applicable Federal rate. Interest income will be recognized by the lender and interest expense will be deducted by the borrower on an economic accrual basis when paid (in the case of a cash method taxpayer) or when due (in the case of an accrual method taxpayer).

The bill generally applies to sales or exchanges after December 31, 1984, except for sales or exchanges with respect to which there was a binding commitment on March 1, 1984. However, as to any transactions entered into after March 1, 1984, and before January

1, 1985, the bill provides that a deduction will not be allowed for interest in excess of the amount properly allocable to the period.

D. Tax Treatment of Corporations and Their Shareholders

1. Dividends received by corporations

a. Debt financed portfolio stock

Under present law, when a corporation borrows the funds used to purchase dividend-paying stock, interest on the acquisition indebtedness is generally deductible against ordinary income. Dividends received by a corporation are eligible for an 85-percent dividend received deduction. Thus, a corporation that borrows to finance purchases of portfolio stock effectively converts some ordinary income to dividend income, which is taxed at a maximum rate of 6.9 percent.

Under the bill, the dividends-received deduction is reduced by an amount determined by reference to interest paid or accrued on debt that is directly attributable to the investment in the underlying stock. The provision applies to stock the holding period for which begins after the date of enactment.

b. Dividends from regulated investment companies

Under present law, a mutual fund, or regulated investment company (RIC), is not subject to Federal income tax if it distributes its income to its shareholders. If at least 75 percent of a RIC's gross income consists of dividends from domestic corporations, then the entire amount of the RIC's dividends to its shareholders is eligible for the 85-percent intercorporate dividends-received deduction. Taxpayers have organized RICs to take advantage of this tax provision that permits the conversion of interest income into dividend income.

Under the bill, the 75-percent rule of present law is raised to 100 percent for corporate shareholders with respect to eligibility for the dividend-received deduction. The provision applies with respect to taxable years beginning after the date of enactment.

c. Extraordinary dividends

Under present law, dividends received by a corporation generally have no effect on its basis in the stock of the distributing corporation. As a result, a corporation can buy stock for $100, receive a $15 extraordinary dividend on it, and then in short order sell the stock for $85. While some portion (generally 15 percent) of the $15 dividend will be taxed as ordinary income to the recipient corporation, the transaction, which has no economic consequences, will also generate $15 of short-term capital loss on the sale of the stock. This is an attractive transaction for corporations that have capital gains which can be sheltered by the loss on the sale of stock.

Under the bill, if a corporate shareholder does not hold stock for more than one year, the fair market value of any extraordinary dividend (to the extent not subject to tax) reduces its basis in the

31-409 O - 84 - 67 BK 1

stock. Extraordinary dividends include dividends received within any 90-day period with a fair market value equal to or greater than 10 percent (five percent in the case of preferred stock) of the taxpayer's basis in the stock. This change applies to distributions after March 1, 1984.

The holding period is limited to exclude, among other periods, any period during which the taxpayer is the grantor of a deep-in-the-money option with respect to the stock, or any period that the taxpayer's risk of loss is substantially diminished because of holding other positions. A similar rule is adopted for all purposes of the holding period rules applicable to the dividends received deduction. The holding period provision applies to positions acquired after the date of enactment. A corporate shareholder's holding period for property received as a dividend with respect to stock is limited so that it cannot exceed its holding period for such stock. This change applies with respect to distributions declared after the date of enactment.

2. Ordinary nonliquidating dividends of appreciated property

Generally, under present law, a distribution of appreciated property (such as interests in an oil and gas royalty trust) by a corporation with respect to its stock is not a taxable event to the distributing corporation.

Under the bill, in general, an ordinary nonliquidating distribution of appreciated property is taxable to the distributing corporation. Certain exceptions are provided. The provision applies with respect to distributions declared after the date of enactment with a transition rule.

3. Transactions in mutual fund shares

Under present law, mutual fund distributions from capital gain income are taxed as long-term capital gain to shareholders even when made to a shareholder who has held the share for one year or less. If a shareholder who has held a share of a mutual fund for less than 31 days sells such share at a loss after a capital gain dividend has been received, the loss is treated as long-term rather than short-term to the extent of the capital gain dividend. Similar rules apply to real estate investment trusts.

Under the bill, losses on mutual fund stock held less than six months are treated as long-term losses to the extent of any capital gain dividends paid on the stock. There is an exception for periodic redemption plans. A similar rule is provided for real estate investment trusts. The provision applies to losses with respect to shares of stock with respect to which the taxpayer's holding periods begin after the date of enactment.

4. Expenses incurred in connection with short sales

A short sale is a transaction in which the investor borrows stock, sells the stock, and later buys stock to repay the loan. Under present law, amounts paid by the taxpayer to the lender in lieu of dividends are deductible against ordinary income. A taxpayer can create short-term capital gain and ordinary loss by selling short before a dividend payment date and closing the short sale after the dividend date in a transaction with essentially no economic consequences.

Under the bill, in the case of a short sale of stock, payments in lieu of dividends are not deductible against ordinary income unless the short sale is held open for at least 16 days. No deduction is allowed for payments in lieu of extraordinary dividends unless the short sale is held open for at least one year. Amounts disallowed are treated as part of the basis of the short seller in the stock acquired to close the short sale. Amounts not disallowed as a deduction are treated as interest for certain Code purposes. The provision applies with respect to short sales after the date of enactment.

5. Transactions in stock warrants

Present law is unclear as to the tax consequences of a corporation's dealing in its own warrants. Under present law, taxpayers with a gain may take the position that no gain is recognized and taxpayers with a loss may report the loss.

Under the bill, no gain or loss is recognized by a corporation on any transaction with respect to a warrant to buy or sell its own stock. The provision applies with respect to warrants acquired or lapsing after the date of enactment.

6. Investment companies that accumulate earnings

Under present law, a corporation may deduct 85 percent of the dividends it receives on portfolio stock investments. Furthermore, gain on the sale of stock held by an individual for more than one year is generally taxed as long-term capital gains at rates not in excess of 20 percent. As a result, if a widely-held investment company invests in dividend-paying stocks and pays no dividends, its shareholders could hold the stock for at least a year and then sell it at a price that reflects dividends received and retained by the company. Their gains would generally be long-term capital gain, so individual shareholders would essentially be recognizing dividend income at a tax rate substantially below 50 percent. The company may take the position that it is not subject to the accumulated earnings tax because it is widely-held.

Under the bill, widely-held companies are not automatically excluded from the accumulated earnings tax.

Also, the net capital loss deduction is denied for mere investment or holding companies and amended, along with other provisions, for other companies. This provision applies with respect to taxable years beginning after the date of enactment.

7. Exchange of debt for stock

Under present law, a corporation recognizes gain when it buys back its debt at less than par value. The gain may be deferred. However, a corporation does not recognize gain when the debt is repurchased by issuing its own stock. Thus a corporation is treated differently where it raises cash to discharge its debts by issuing new stock and where it discharges the debt by issuing stock directly.

The bill provides that the scope of the "stock for debt" exception is limited to insolvent corporations or corporations under title 11. The provision applies to transfers after the date of enactment.

8. *Distribution of debt by a corporation*

Under present law, earnings and profits of a corporation are reduced by the principal amount of its obligations distributed to shareholders. Generally, for noncorporate shareholders, the amount of a distribution taken into account is the fair market value of the property distributed. A long-term obligation bearing little or no stated interest will have a present fair market value well below its stated redemption price. The result may be to eliminate corporate earnings and profits at the cost of a relatively small dividend to shareholders.

The bill amends the earnings and profit rules to limit the reduction in earnings and profits resulting from the distribution of the corporation's own debt obligations. Also, under the bill, these obligations are subject to the original issue discount rules. This provision applies with respect to distributions made after the date of enactment.

9. *Definition of affiliated group of corporations*

Under present law, an affiliated group of corporations is permitted to file a consolidated return. For certain tax rules, an affiliated group of corporations is treated as a single corporation. Affiliation may be achieved even though convertible preferred stock, or convertible common stock with a very small vote, with a significant equity value is owned by outsiders.

The committee bill amends the definition of "affiliated group" to require 80 percent of the equity as well as 80 percent of the voting power in order to consolidate. Rules relating to deconsolidation are also provided. The provision applies with respect to taxable years beginning after December 31, 1984. Transitional rules are provided.

10. *Transfers of depreciable property between related taxpayers*

Present law provides that a transferor will be treated as receiving ordinary income rather than capital gain on the transfer of property to a related party when that property is depreciable property in the hands of the transferee. The courts have held that the transfer of a patent application as opposed to a patent does not fall within this anti-abuse rule because the application itself is not depreciable property. However, once the application is granted, the transferee can depreciate the resulting patent.

The bill amends the present law rules to treat a patent application as depreciable property, thus requiring that any gain recognized to the transferee be treated as ordinary income rather than capital gain. The bill broadens the rule to cover, generally, sales between a taxpayer and a trust in which the taxpayer or the taxpayer's spouse have a beneficial interest. This provision applies to transfers made after March 1, 1984.

11. *Collapsible corporations*

Under present law, a collapsible corporation, generally, is one formed or availed of principally for the manufacture, construction, production, or purchase of certain types of property with the view to the sale or exchange by the shareholders of their stock (or of the liquidation of the corporation) before the realization by the corporation of a "substantial" part of the taxable income to be derived from such property. If a stock is a collapsible corporation is sold, exchanged, or the corporations is liquidated in whole or in part (i.e., collapsed), or in the case of certain distributions, any gain recognized by any shareholder in any such sale, exchange, liquidation, or distribution which would otherwise be long-term capital gain is considered ordinary income.

Under court decisions a corporation will have realized a "substantial" part of the taxable income to be derived from the property if the corporation realizes as little as one-third of the taxable income to be derived from the property. Present law also provides an exception to collapsible corporation treatment (the "70/30" rule). In general, under this rule, if 70 percent or less of a shareholder's total gain in a taxable year is attributable to collapsible assets of the corporation, then none of the recognized gain in such year is treated as ordinary income.

Under the bill, the substantial part required is defined as two-thirds of the taxable income to be derived from the property. Conforming changes are made to the "70/30" rule to prevent corporations from otherwise avoiding the collapsible corporation provision. These changes are effective on the date of enactment.

12. Net operating losses

Provisions from the Tax Reform Act of 1976 relating to special limitations on the carryover of net operating losses and other tax attributes are scheduled to become effective at varying times during 1984.

The bill delays the effective date of those provisions. As a result, the rules in effect prior to 1984 remain in effect.

E. Partnership and Other Pass-through Entities

1. Allocations of partnership income or loss

a. Contributed property

Under present law, a partnership may elect to allocate gain or loss and depreciation or depletion with respect to contributed property to reflect variations between the basis of the property and its fair market value when contributed. In the absence of the election, gain or loss with respect to contributed property can be effectively shifted among members of the partnership.

Under the committee bill, the special allocation of gain or loss, and depreciation or depletion with respect to contributed property will be made mandatory so that a partnership will generally have to allocate pre-contribution gain or loss to the contributing partner. The provision applies to contributions made after March 31, 1984.

b. Partnership losses

Under present law, retroactive allocation of partnership deductions to partners entering late in the year is prohibited. Nonetheless, it may be possible to accomplish such an allocation through the use of tiered partnerships or, in the case of cash method partnerships, by delaying actual payment for accrued expenses.

With respect to the tiered partnership technique, the bill would require income, gain, loss, deduction and credit passing from a subsidiary partnership to a parent partnership to be allocated equally among the days in the parent's taxable year for which it has an interest in the subsidiary. Further, for cash basis partnerships, certain items such as taxes, interest, and rents are to be allocated proportionately over the periods to which they relate, so that a partner can deduct only those items actually accrued while he is a partner. The provision applies to items paid or accrued after March 31, 1984.

c. Treatment of certain liabilities

The bill provides for regulations with respect to determining a partner's allocable share of partnership liabilities which will produce economically sound results and, among other things, overrule the holding of the U.S. Claims Court in *Raphan* v. *United States*.

2. Conversion or deferral of income

a. Gain or loss on contributed property

Present law provides that if certain ordinary income property of a partnership is distributed to a partner, its character as ordinary income property is preserved in the hands of the distributee for at least five years. No comparable rule applies to property contributed to a partnership. Thus, it may be possible to change the character of property from ordinary income to capital gain or from capital loss to ordinary loss through a contribution to a partnership.

Under the bill, the ordinary income or loss character of unrealized receivables contributed to a partnership will be preserved in the hands of the partnership. Further, the ordinary income or loss character of inventory items would be preserved in the hands of the partnership for five years. Built-in losses on capital assets contributed to a partnership are treated as capital losses if recognized by the partnership within 5 years. The provision applies with respect to property contributed after March 31, 1984.

b. Organizational fees and other capital expenditures

Under present law, amounts expended to organize or promote a partnership generally must be capitalized. Other payments for property or services may also be required to be capitalized. It has been suggested that these capitalization requirements may, in effect, be avoided when the payee is also a partner by allocating a greater share of income to that partner.

The bill provides that when a partner performs services for, or transfers property to, a partnership and receives a related allocation of partnership income or gain, the transaction will be treated as occurring between the partnership and a person who is not a partner. Thus, the amount of the allocation is to be capitalized. The provision applies to transactions occuring after March 1, 1984.

c. Disguised sales

Under present law, a partner may be able to avoid recognition of gain on the sale of property to a partnership or another partner by characterizing the transaction as a contribution of the property followed by a distribution of cash or other property to the contributing partner.

The bill provides that, when appropriate, a transfer of property to a partnership and a related transfer to the contributing partner will be treated as occurring as a sale between partners or between the partnership and the partner. The provision applies to transfers after March 1, 1984.

d. Ordinary income property in tiered partnerships

Under present law, amounts received by a transferor partner in exchange for all or part of his partnership interest that are attributable to his interest in ordinary income assets of the partnership are treated as ordinary income. It has been argued that this rule can be avoided if ordinary income assets are held in a second partnership in which the distributing partnership holds an interest.

The bill treats a partnership that owns an interest in another partnership as owning its proportionate share of the ordinary income assets of such partnership directly. A similar rule applies to interests in trusts. The provision applies to distributions, sales or exchanges after March 31, 1984.

e. Basis strips

Under present law, a partnership can elect to increase the basis of its assets by the amount of any basis that is "lost" when a distributee partner's basis in his interest is substituted for the basis of distributed property. Thus, a partnership distributing high basis property to a low basis partner will experience an increase in the basis of its other property, but the distributee partner will lose basis and be exposed to greater gain if the distributed property is sold. This result can be avoided by contributing the high basis property to a lower tier partnership which has not elected to make basis adjustments, and by distributing the partnership interest to the low basis partner. The result is that the partnership property of the first partnership will experience a basis increase without reducing the basis of the contributed property.

The bill eliminates the elective basis adjustment for distributions of interests in partnerships that have not elected to make basis adjustments. The provision applies to distributions after March 1, 1984.

3. Like-kind exchanges of partnership interests

Under present law, like-kind exchanges of property held for productive use or investment are permitted to be made tax-free. These rules do not apply to inventory, stock, certificates of trust or beneficial interests, or other securities or evidences of indebtedness. In some cases, the courts have permitted tax-free like-kind exchanges of partnership interests. The Treasury has not acquiesced in these holdings.

The bill provides that tax-free like-kind exchange treatment is not available for exchanges of interest in different partnerships. The provision applies with respect to exchanges after March 31, 1984.

4. Transfers of partnership interests by corporations

Under present law, when a partnership interest is sold, any gain is ordinary income to the extent attributable to certain ordinary income items of the partnership. When a corporation distributes property, or sells property in the course of certain complete liquidations, recapture income is taxed to the corporation while non-recapture gain attributable to appreciation in the transferred property goes unrecognized. It has been argued that the corporate recapture provisions do not apply to the distribution or liquidating sale of an interest in a partnership that holds recapture property.

Under the bill, a corporate distribution or a liquidating sale of a partnership interest, is treated as a transfer of the distributing corporation's allocable share of certain recapture items (and other corporate recognition property) held by the partnership. The amount of income recognized is limited to the gain the corporation would have recognized had it sold the partnership interest. The provision applies to distributions after March 1, 1984.

F. Trust Provisions

1. Multiple trusts

Treasury regulations prevent grantors of trusts from reducing present taxation by establishing multiple trusts for the same beneficiaries which take advantage of the separate graduated rates applicable to each trust. A recent court decision held these regulations to be invalid. Under the bill, trusts established by substantially the same grantors for substantially the same beneficiaries with a principal purpose of tax avoidance would be consolidated for tax purposes under Treasury regulations. The provision is generally effective for taxable years beginning after March 1, 1984.

2. Trust distributions

Under present law, beneficiaries are taxed on amounts distributed from a trust (or estate) to the extent of the trust's (or estate's) distributable net income. The trust (or estate) is allowed a deduction for amounts taxed to its beneficiaries. Distributions of appreciated property are deemed to carry out distributable net income to the extent of the property's value at the time of distribution. The basis of the property in the hands of the beneficiary is its value to the extent it carries out distributable net income.

Under the bill, distributions of property result in gain or loss to the trust or estate. Alternatively, the trustee or executor may elect to treat distributions of property as carrying out distributable net income only to the extent of the property's basis. The beneficiary's basis would be the same as the trust's (or estate's) and the appreciation would no longer be exempted from tax.

The provision applies to distributions after March 1, 1984.

G. Time Value of Money and Other Accounting Provisions

1. Premature accruals

Under the accrual method of accounting, an expense is deductible when all events have occurred which establish the fact of liability and the amount of the liability can be determined with reasonable accuracy. The proper time for deducting expenses for which economic performance has not yet occurred is the subject of controversy under present law.

The bill generally requires that economic performance must occur before all events establishing the fact of liability will be considered to have occurred.

Exceptions are made for items for which specific timing rules are already provided under the Code, such as bad debts and vacation pay. The bill also provides a 10-year carryback for losses arising from certain deferred liabilities and a longer period for certain losses associated with the decommissioning of nuclear generating plants.

The bill applies to expenses accruing after the date of enactment.

2. Prepaid expenses

Except with respect to interest and prepayments by farm syndicates, present law is unclear as to the proper timing of a deduction for prepaid items by cash method taxpayers. In the case of interest, deductions are allowed only for the year to which the interest relates. A similar rule applies to prepaid expenses of farm syndicates.

Under the bill, tax shelter organizations will not be permitted to deduct any amount prior to the time it would be properly deductible under the accrual method of accounting. The bill defines tax shelter organizations to include certain partnerships and enterprises, and any entity, plan or arrangement having the principal purpose of tax avoidance. This rule will apply to prepayments made after the date of enactment.

3. Deferred like-kind exchanges

Under present law, no gain or loss is recognized on the exchange of business or investment property for property of a like-kind. An intended like-kind exchange transaction may be held open for as long as five years under the case law. The bill provides that property received more than 180 days after the taxpayer transfers the relinquished property (or, if earlier, after the due date of the taxpayer's return) will not be treated as like-kind property. This provision will apply to transfers of property made after the date of enactment (or to any exchange closed after 1986).

4. LIFO conformity

Currently, the "Last-In First-Out" (LIFO) method of inventory accounting may not be used for tax purposes unless it is also used in reporting to shareholders, partners, other proprietors, beneficiaries, or for credit purposes. An issue has arisen as to whether a parent company is subject to these LIFO conformity rules when the inventory is held by a subsidiary company. The bill makes the LIFO conformity requirement applicable to financially related corporations as if they were a single taxpayer, effective for taxable years beginning after the date of enactment.

5. Inclusion of tax benefit items

Under present law, an individual taxpayer who receives a State tax refund may exclude from income an amount equal to the excess of the zero bracket amount over the taxpayer's other itemized deductions for the year in which the State taxes were deducted. This exclusion is permitted even though the deduction of this amount in the prior year resulted in a tax benefit.

The bill provides that where a taxpayer recovers a previously-deducted amount, the recovered amount is excluded from gross income only to the extent such amount did not reduce income subject to tax. The bill also requires an increase in tax for any year in which an amount relating to a credit claimed in a prior year is recovered, except to the extent that the credit did not reduce the amount of tax. This provision will not apply to amounts recovered relating to foreign tax credits and investment tax credits, the treatment of which is governed by existing law. This provision will apply to amounts recovered after 1983.

6. Low-interest and interest-free loans

Under present law, loans between family members generally result in taxable gifts in an amount equal to the value of the interest that is not charged. No income tax consequences result, however, to either the lender or the borrower. Demand loans by corporations to their shareholders, and to persons providing services by persons for whom the services are provided generally do not have any Federal tax consequences.

Under the bill, low-interest and interest-free loans generally are to be recharacterized as (1) a loan to the borrower at a statutory interest rate, and (2) either a gift (in the case of a family transaction), dividend (in a corporation-shareholder transaction), or compensation (in a transaction involving services), or some other payment in accordance with the substance of the transaction. The borrower is treated as paying interest on the loan at the statutory rate, resulting in income to the lender and a deduction to the borrower. An exception is provided for non-tax motivated transactions. This provision is effective on March 1, 1984, except with respect to demand loans repaid within 60 days of the date of enactment.

7. Income averaging

Income averaging is presently available to taxpayers with "averageable income". Averageable income is current year taxable income in excess of 120 percent of average taxable income in the four preceding years. In effect, income averaging widens the tax brackets by a factor of five with respect to averageable income.

The bill increases the 120-percent requirement to 140 percent and provides that only the three preceding years are to be taken into account. The bill modifies income averaging so that it, in effect, widens the tax brackets by a factor of four, not five, with respect to averageable income.

These changes are effective for taxable years beginning after December 31, 1983.

H. Straddles and Other Securities Transactions

Under present law, several special rules apply to limit tax benefits from straddle transactions. Under the loss deferral rule, losses on straddles are deferred to the extent of gains on offsetting positions. However, there is an exception from this rule for straddles involving stock and stock options. Also, a mark-to-market system applies to regulated futures contracts under which taxes are paid on unrecognized gains and losses at the end of each year. Under the mark-to-market rules, gains and losses are treated as 60-percent long-term and 40-percent short-term, providing a maximum tax rate of 32 percent. The tax treatment of options on futures contracts and cash settlement options is unclear under present law.

The bill repeals the exception from the loss deferral rule for stock options and substitutes a limited exception applying to covered calls which are not deep-in-the-money. The exception from the straddle rules for stock would only apply where both legs of the straddle consist of positions in stock. When a taxpayer has written an in-the-money covered call, any long-term gain on the sale of the stock will be recharacterized as short-term to the extent of any short-term losses on the option.

The bill also extends the mark-to-market system to options on futures contracts, to options where the underlying property is not equity based, to options on broad-based equity indexes, and to options held by options market makers.

The bill modifies the hedging exception to the anti-straddle rules to reduce the possibility that it may be used to generate losses that shelter unrelated income from tax.

The Treasury Department's authority to issue regulations with regard to the straddles rules is extended so that it can deal with the problems presented under present law by mixed straddles.

The bill clarifies the treatment of cash settlement options.

The repeal of the exception for stock options from the anti-straddle rules is effective for positions entered into after October 31, 1983. The extension of mark-to-market rules is effective for positions entered into after the date of enactment. Transition rules are provided similar to those which were provided when the mark-to-market system for regulating futures contracts was implemented in 1981.

I. Employee Benefit Provisions

1. Deductions for contributions to funded benefit plans

The bill provides new rules for determining the timing and the amount of an employer's deduction for a contribution to a funded welfare benefit plan. Under the bill, a contribution which is otherwise deductible under the Code generally will be deductible only to the extent that it does not exceed the amount a cash-basis employer could deduct if the benefit were paid directly under an unfunded arrangement, plus an addition to a funded reserve generally permitted to equal 75 percent of average benefit costs. This provision will apply to employer contributions paid or accrued after March 31, 1984, to funded welfare benefit plans in taxable years ending after that date. A delayed effective date is provided for the welfare benefit plans covering collective bargaining units.

2. Unfunded deferred benefits

Under present law, the tax treatment of an employer with respect to employee benefits may depend upon whether the benefit is deferred compensation or a welfare benefit. Present law does not clearly distinguish between these two types of benefits. The bill clarifies the distinction between welfare benefits and deferred compensation. In addition, it clarifies that all non-qualified deferred compensation arrangements are subject to the deduction timing rules of current law. The provision applies to amounts paid or incurred after March 31, 1984 in taxable years ending after that date.

3. Additional requirements for tax-exempt status of VEBA

The bill provides that an association that is otherwise exempt from tax as a voluntary employees' beneficiary association (VEBA) or a supplemental unemployment compensation benefit trust (SUB) will not be tax exempt unless it meets new standards provided by the bill. For VEBAs, these standards provide more effective rules prohibiting discrimination in favor of highly compensated employees, and, for VEBAs and SUBs, they limit the portion of a benefit that may be used by highly compensated employees. Under the bill, the rules aggregating employees of related employers for purposes of testing qualified pension plans will apply (with modification). These new nondiscrimination standards do not apply to a VEBA maintained pursuant to a collective bargaining agreement. The bill also clarifies present law with respect to the notice required as to recognition of exempt status. The provision applies for taxable years beginning after December 31, 1984.

4. Tax on unrelated business income

Present law imposes a tax on the unrelated business income of a tax-exempt organization. In the case of a voluntary employees' beneficiary association (VEBA) or a supplemental unemployment compensation benefit trust (SUB), the tax is imposed on income not set aside for the exempt purpose of the association. Present law, however, does not establish clear limits on the amount that may be set aside.

Under the bill, the amount set aside is not to exceed the level of the qualified asset account determined under the rules relating to deductions for contributions to a VEBA or SUB. The provision applies to taxable years beginning after December 31, 1984.

5. Treatment of gain on property transferred from employer and employee benefit associations

Under present law, special rules deny capital gain treatment on sales of depreciable property between related parties. Present law, however does not treat an employer and an exempt organization controlled by the employer as related parties. Under the bill, certain exempt organizations will be treated as related parties with respect to an employer under the rules of the Code treating gain on related-party sales of depreciable property as ordinary income. The provision applies to sales or exchanges after December 31, 1984.

6. Treatment of certain medical, etc., benefits

In applying the overall limits on contributions and benefits under qualified plans, the bill provides that any contributions allocated to an individual medical benefit account of an employee under a qualified defined benefit plan is to be treated as an annual addition under a qualified defined contribution plan. Accordingly, the amount allocated for a year will be included, together with employer contributions and reallocated forfeitures, in determining whether the defined benefit plan and any defined contribution plan of the employer meet the separate limits and the combined limits provided with respect to such plans. The provision applies to years beginning after March 31, 1984.

7. Accrual of vacation pay

Present law generally limits the accrual of vacation pay on the basis of vacation pay earned by the end of the year and payable before the close of the succeeding year. The bill limits the accrual of vacation pay on the basis of vacation pay earned by the end of the year and expected to be paid before the close of the succeeding year. This provision applies to taxable years beginning after March 31, 1984.

8. Determination of whether there is a collective bargaining agreement

Under present law, special rules relating to employee benefits apply with respect to plans covering collective bargaining units. Some of these rules provide effective dates that are more appropriate for these plans. In other cases, rules forbidding discrimination in favor of highly compensated employees are modified or waived with respect to employees included in a collective bargaining unit.

The bill clarifies present law by providing that, in determining whether there is a collective bargaining agreement between employee representatives and one or more employers, an organization is not to be considered an employee representative if more than one-half of its members are employees (including a self-employed individual who is considered to be an employee under the rules for qualified pension plans) who are owners, officers, or executives of the employer. This provision is effective on April 1, 1984.

9. Disqualification of plan where substantially all coantributions are employee contributions

The bill provides that a plan is not a tax-qualified pension, profit-sharing, or stock bonus plan if substantially all of the accrued benefits under the plan are derived from employee contributions (whether or not deductible). The provision applies to plan years beginning after March 31, 1984.

10. Discrimination rules for cash-or-deferred arrangements

Under present law, an employee may elect to defer compensation (within limits) under a qualified cash-or-deferred arrangement that is provided by a tax-qualified profit-sharing or stock bonus plan. Permitted deferrals are generally not taxed until they are distributed. In determining whether a cash-or-deferred arrangement meets the standards of the Code either a special nondiscrimination standard for cash-or-deferred arrangements or the general qualified plan nondiscrimination standard, which allows employee social security taxes to be treated as employer contributions, may be applied.

Under the bill, a cash-or-deferred arrangement will be a qualified cash-or-deferred arrangement (and elective deferrals are not includible in gross income) only if it meets the special tests provided by the Code relating to actual deferral percentages. The failure of a cash-or-deferred arrangement to meet the special tests will not result in the disqualification of a plan if the plan meets the usual requirements for qualification. This provision is effective for amounts paid or incurred after March 31, 1984.

J. Foreign Provisions

1. Factoring trade receivables

Under present law, a seller who sells goods for the buyer's receivable (a transferable debt) may sell that receivable to a third party—a factor—at a discount. If a U.S.-owned factor is in a tax haven, it may earn income free of U.S. tax. That income may be eligible for deferral, and it may be foreign-source income that is sheltered by excess foreign tax credits. Further, when a foreign subsidiary of a U.S. corporation invests in U.S. property, that investment is taxable as a dividend to the U.S. parent. Some taxpayers allege that this rule does not apply to a foreign factoring subsidiary that buys receivables from its U.S. parent.

Under the bill, when a foreign factoring subsidiary of a U.S. owner gets cash for a receivable that (1) it bought from a related person, and (2) the related person had taken in exchange for inventory, the U.S. owner is taxed on that factoring income. The bill treats income from a related U.S. person's receivables as U.S. income. The bill also treats payments of cash from a foreign subsidiary to a related U.S. person for receivables arising from the U.S. person's sales of inventory as investments in U.S. property. Thus, payments of cash for receivables will be taxable as dividends to the U.S. parent. This provision will apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984 in taxable years ending after that date.

2. Transactions involving foreign corporations

a. Certain transfers of appreciated property to foreign corporations

Under present law, certain transfers of appreciated assets to foreign corporations in reorganizations and liquidations, which would be tax-free, are taxable if the Internal Revenue Service rules that one of the principal purposes of the transfers was the avoidance of Federal income tax. Under Internal Revenue Service guidelines, generally, transfers of property used in the active conduct of a foreign trade or business are not taxed. However, also under those guidelines, transfers of assets containing built-in gain (such as inventory and accounts receivable) are generally taxed.

Judicial interpretation of the principal purpose test has reduced the ability of the Internal Revenue Service to administer section 367. In addition, the Internal Revenue Service's current ruling policy permits the tax-free transfer of intangible property abroad, where the development of the property generated significant U.S. tax benefits but the income derived from the property may escape U.S. taxation. Finally, the courts have rejected the Internal Revenue Service's requirement that certain losses be recaptured upon the incorporation of a foreign branch by a U.S. person.

Under the bill, the rules governing transfers of appreciated property abroad are amended to provide for gain recognition without regard to purpose, unless the property is transferred for use in an active trade or business abroad. Certain transfers of assets containing built-in gain are automatically subject to tax. Transfers of stock are subject to the active trade of business test. In addition, transfers of intangibles for less than full consideration are subject to tax. Full consideration includes an arm's length royalty. The intangibles rule does not apply to good will or going concern value developed by a foreign branch. Finally, the current Internal Revenue Service policy on incorporations of foreign branches is codified. The provision applies to transfers after January 1, 1985.

b. Decontrol of foreign corporations

Under present law, when a U.S. taxpayer who is a 10-percent shareholder of a controlled foreign corporation sells or exchanges stock in a taxable transaction, the gain is treated as ordinary (dividend) income to the extent of the shareholder's pro rata share of the corporation's post-1962 accumulated earnings and profits. A U.S. corporation that disposes of stock by distributing it as a dividend-in-kind or in the course of liquidation, in a transaction eligible for nonrecognition treatment to the U.S. corporation, is also required to include in income its share of post-1962 accumulated earnings and profits. Taxpayers have taken the position that section 1248 does not apply if a controlled foreign corporation that is wholly owned by a U.S. corporation issues new shares for shares of the U.S. corporation. If this position were sustained, such a transaction could lead to permanent exemption from U.S. corporate tax of the earnings of the controlled foreign corporation accumulated prior to the exchange.

Under the bill, certain exchanges by a controlled foreign corporation of its newly issued stock for shares of its U.S. parent corporation are treated as sales or exchanges by the U.S. parent of stock in the controlled foreign corporation. The provision applies as of the date of enactment.

c. Recharacterization of U.S. income as foreign income

Under present law, the United States taxes the U.S. income of U.S. taxpayers. U.S. taxpayers' foreign income can be free of U.S. tax under the foreign tax credit. U.S. taxpayers can place the "foreign" label on some U.S. income (such as interest and insurance premiums) by routing it through a foreign corporation. This foreign corporation distributes foreign dividends to its U.S. owners. This newly foreign income may escape U.S. (and foreign) tax.

The bill prevents re-labelling of U.S. income as foreign income. Under the bill, if a corporation, 10 percent (or more) of whose gross income is U.S. income (including U.S. business income), pays interest or dividends to a U.S. taxpayer, a pro rata portion of the payment is U.S. income. The bill applies only to 50-percent U.S-owned corporations. Generally, it applies with respect to income earned by paying corporations after the date of enactment.

d. Recharacterization of interest income as dividend income

Under present law, a U.S. taxpayer's foreign interest income cannot escape both U.S. and foreign tax (under the United States' separate foreign tax credit limitation that prevents foreign taxes on non-interest income from offsetting U.S. tax on foreign interest income). U.S. taxpayers seek to circumvent this rule by creating foreign subsidiaries to earn foreign interest income (for example, by depositing money in foreign banks). When the U.S. taxpayer is taxable on the earnings of its foreign subsidiary, its income is dividend income, not interest income. Thus, newly recharacterized "non-interest" income may totally escape both U.S. and foreign tax.

The bill treats foreign dividends as interest to the extent that the paying corporation's earnings and profits arise from interest. This rule applies only if 10 percent or more of the paying corporation's earnings and profits for the three taxable years preceding the taxable year in which the dividend is paid arise from interest. The provision generally applies to income earned by paying corporations after the date of enactment.

e. Use of territories to avoid U.S. tax

Under present law, payments of U.S. source interest, dividends, and other passive income to foreign investors are generally subject to a 30-percent U.S. withholding tax. The United States does not tax payments of passive income to corporations organized in Guam, the Northern Mariana Islands, or the U.S. Virgin Islands. Some argue that foreigners who wish to invest in the United States may avoid both U.S. and territorial tax by channeling their investments through conduit corporations in these territories.

Temporary Treasury regulations subject dividends and interest paid by territorial conduit corporations to territorial withholding tax. Guam is contesting these regulations in court.

Under the bill, interest, dividends, and other passive income paid from U.S. sources to corporations organized in Guam, the Marianas, or the Virgin Islands are subject to U.S. tax unless the bulk of the recipient's gross income is from territories and unless the bulk of its beneficial owners are local residents. The provision applies with respect to payments made after March 1, 1984.

f. Source of transportation income

Under present law, in general, the United States taxes all U.S. income, but not all foreign income, of United States persons. In general, the United States does not tax the foreign income of foreign persons (such as foreign corporations). Under present law, transportation income can be almost all foreign even if the transportation is between two U.S. points, if the route of transport lies primarily outside the United States' three mile territorial limit.

Under the bill, income earned from transportation that begins and ends in the United States (or U.S. possessions) is treated as U.S. income. Income earned from transportation includes services income and leasing income from ships, airplanes, and containers used in connection with ships and airplanes. The effective date is the date of enactment.

g. Foreign collapsible corporations

Under present law, sales of inventory yield ordinary income, not capital gain. "Collapsible" corporations' assets generally include inventory. Generally, a shareholder's gain on the sale or liquidation of a collapsible corporation is ordinary income rather than capital gain. However, if a collapsible corporation consents under section 341(f) to recognize ordinary income on disposition of its inventory and the like, the shareholder gets capital gain treatment on the sale or liquidation of the corporation. In the case of a consenting foreign corporation, enforcement of the consent may be impractical.

Under the bill, to the extent provided in regulations, foreign corporations are ineligible to make consents under setion 341(f). The effective date is the date of enactment.

K. Compliance Provisions

1. Promoter's customer lists

Present law does not require promoters of potentially abusive tax shelters to keep customer lists available to the Internal Revenue Serivce. The bill requires promoters of investments having a potential for tax avoidance or evasion to maintain customer lists in the manner provided by Treasury regulations. The bill provides a $50 penalty per failure to list a customer, up to $50,000 per year. This provision is effective on the date of enactment.

2. Mortgage interest reporting

No informational reports are required under present law with respect to amounts deductible by individual taxpayers who itemize their deductions. The bill requires persons (including governmental units) who receive mortgage interest payments in the course of a trade or business to report annually to the Internal Revenue Service the amount of the interest, and the person from whom the payment is received. The payor must be provided a copy of the report. Payments aggregating less than $600 are exempt. The bill generally provides for a $50 penalty per failure to comply. This provision will apply to payments after December 31, 1984.

3. Foreclosure reporting

Under present law, foreclosures in satisfaction of a debt or forgiveness of a debt may give rise to income to the debtor which may be treated as ordinary income under the recapture rules. The bill requires persons lending in the course of a trade or business to report to the Internal Revenue Service, except in the case of consumer loans, when a debt of $15,000 or more is satisfied in full or in part by a foreclosure, an acquisition of property, or an abandonment of security for a loan. The bill generally provides for a $50 penalty per failure to comply. This provision will apply to foreclosures, acquisitions of property and abandonments of security for a loan taking place after December 31, 1984.

4. Promoter's penalty

The Tax Equity and Fiscal Responsibility Act of 1982 provides for a penalty on promoters of abusive tax shelters equal to the greater of $1,000 or 10 percent of income from the activity. The bill increases the 10-percent penalty to 20 percent, effective the day after the date of enactment.

5. Reporting of State income tax refunds

State and local governments are required under present law, to provide information to the Internal Revenue Service on refunds of State or local income tax, and to supply a copy to the taxpayer in

January of the following year. Under temporary regulations, the Treasury Department has provided that reporting is not required when the officer making the refund determines that the individual received no Federal tax benefit from the tax payment to which the refund relates. The bill codifies the provisions of the temporary regulations providing exceptions from the reporting requirement. This provision of the bill applies to refunds, credits, and offsets allowed after December 31, 1982.

6. Practice of appraisers

The Treasury Department presently has no authority to prevent disreputable appraisers from providing appraisals for use on tax returns or from appearing in proceedings before the Treasury Department. The bill provides that the Treasury Department may bar appraisers who aid or assist in the preparation of false returns or other documents from practice before it. This provision will be effective on the date of enactment.

7. IRA reporting

Present law generally allows an individual to deduct the amount of qualified individual retirement account (IRA) contributions made for a year, either during the year or before the due date of the income tax return for the year. In the absence of reporting by the trustee or issuer, the Internal Revenue Service has difficulty verifying whether contributions were made and the year to which they relate. The bill clarifies the authority of the Treasury Deparment to require reporting on contributions to IRAs by the trustee or issuer. Reports are to include the amount and the year to which a contribution relates. The bill generally provides for a $50 penalty per failure to comply. This provision will apply to contributions made after April 15, 1984, and relating to 1984 and subsequent years.

8. Disposition of partnership interests

When a partnership interest is sold or exchanged, the transferred partner may have reportable gain or loss under present law. In addition, if the value received is attributable to appreciated inventory or unrealized receivables that could produce ordinary income if sold by the partnership, the transferor will be treated as having realized ordinary income. The bill requires a partnership to inform the Internal Revenue Service, the seller and the buyer of the fair market value of the allocable share of unrealized receivables and appreciated inventory when partnership interests are sold or exchanged. A $50 penalty generally is imposed for each failure to comply. This provision will apply to sales and exchanges made after 1984.

9. Dividends-received deduction—compliance

Under present law, a broker who holds stock in a street name for a customer may lend that stock to another customer for use in a short sale. The short-seller sells the borrowed stock with the expectation that the price of the stock will decline and expects to be able to purchase stock to return to the lending broker at a price below the proceeds of the sale. If a dividend is paid on the borrowed stock, the short-seller must pay the lender an amount in lieu of the dividend. The actual dividend is received by the purchaser in the short sale. If the borrowed stock belonged to a corporate client of the broker, the corporation is not entitled to the dividends-received deduction on the amount of the payment received in lieu of the dividend.

Under the bill, the broker reporting rules are amended to require brokers to provide a statement to corporate customers of amounts paid in lieu of dividends by reason of short sales. This provision applies to payments in lieu of dividends made after January 1, 1985.

L. Other Miscellaneous Reform Provisions

1. Limitation on depreciation and investment tax credit for luxury automobiles

Present law allows an investment tax credit and cost recovery deductions on the cost of an automobile used for a business or income-producing purpose. The bill limits the investment credit and cost recovery deductions to the first $21,000 of cost, effective for automobiles placed in service after March 1, 1984. Also, it institutes a rebuttable presumption that at least 50 percent of the use of any automobile during any taxable year is personal use, effective in taxable years beginning after 1984.

2. Investment income from S corporations

Under present law, an individual's deduction for investment interest is generally limited to the taxpayer's net investment income plus $10,000. The bill provides that, for purposes of this provision, the net gain from a subchapter S corporation (existing prior to the adoption of the Subchapter S Revision Act of 1982) will be treated as investment income if capital is a material income-producing factor in the S corporation, except for the income that is attributable to personal services of the taxpayer. The provision will apply to taxable years beginning after December 31, 1982 and will sunset December 31, 1984.

3. Excise tax payments to Puerto Rico and the Virgin Islands

Under present law, a special excise tax is imposed on certain articles coming into the United States from Puerto Rico and the Virgin Islands. Revenues from the special tax are paid to the Puerto Rico and the Virgin Islands. Puerto Rico presently conducts a program under which distilled spirits from the United States are redistilled in Puerto Rico and reshipped to the United States, thereby enabling Puerto Rico to receive an excise tax payment.

Under the bill, revenues from excise tax on articles coming into the United States from Puerto Rico and the Virgin Islands will be paid to those possessions only (1) in the case of distilled spirits, if at least 90 percent of the distilled spirits were originally distilled in Puerto Rico or the Virgin Islands; (2) in the case of any article subject to Federal excise tax which comes into the United States from Puerto Rico, if 50 percent or more of the value of the article is attributable to Puerto Rican input; and (3) in the case of any article subject to Federal excise tax, if the applicable possession provides no subsidy to the industry involved of a kind different from that provided to industry generally. A general exemption is provided for rum; a limited exception from (2) and (3) is provided for cane neutral spirits meeting test (1).

This provision of the bill generally will apply to articles coming into the United States after February 29, 1984. However, a transition rule permits payments of $130 million of tax with respect to redistilled spirits between July 1, 1983 and June 30, 1984; this amount is reduced to $75 million for the period July 1, 1984 through June 30, 1985.

Title II.—Life Insurance Tax Provisions

1. Company taxation

Under present law, life insurance companies may be taxed on different tax bases. As a consequence, different companies derive varying degrees of benefit from the various reserve special deductions generally allowable only to life insurance companies and reserve computation rules of present law.

In lieu of the present law three-phase pattern of taxation which applies to life insurance companies, the bill provides a new single-phase tax structure. This structure embodies the tax rules applicable to corporations generally except that certain special rules apply to address issues unique to the life insurance industry.

a. Computation of the deduction for reserves

Under the bill, deductions for additions to reserves more closely reflect each company's liabilities to policyholders than do solvency reserves used for State law purposes. Further, the deductions are computed on the basis of uniform rules regardless of the particular assumptions used for purposes of computing statutory reserves.

Under these rules, a life insurance company can deduct an amount equal to the excess of the higher of (1) the net surrender value of the contracts or (2) the Federally prescribed reserve, over the amount of the reserve for tax purposes at the end of the prior year. The Federally prescribed reserve is the reserve computed using assumptions that generally reflect the minimum assumptions permitted to be made under most State laws.

b. Limitation on mutual company deductions

A mutual life insurance company is owned by its policyholders. These policyholders receive distributions from the company which may represent price reductions or other policyholder benefits, interest, or returns on the policyholders' investment in the enterprise.[1] Under the bill, amounts distributed by a mutual company to policyholders are, in effect, fragmented, and no deduction is allowed at the company level for amounts distributed to policyholders in their capacity as owners of the company. This is accomplished by means of an ownership differential provision. Under this provision, each mutual company's deductions for payments and credits to policyholders are reduced by the amount of an imputed return on the company's equity. There is a special 5-year transition rule for certain high surplus mutuals.

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[1] In contrast, a stock life insurance company is owned by shareholders. Although a stock company may pay policyholder dividends to its policyholders, such amounts would generally include only price reductions and policyholder benefits.

The bill also mandates a study in which the Treasury would analyze the operation of the ownership differential provision in its first 3 years.

c. Stock life insurance subsidiaries of mutual companies

As a general rule, under the bill, a stock life insurance subsidiary of a mutual life insurance company is treated as a stock company for tax purposes. However, for purposes of computing the limitation on mutual company deductions, the equity of a stock subsidiary is included in the mutual parent.

d. Special rule for small companies

Under the bill, a small life insurance company is allowed a deduction equal to 60 percent of the first $3 million of its otherwise taxable income. This deduction phases out as otherwise taxable income increases from $3 million to $15 million. The amount of this deduction is computed on the basis of a controlled group and does not apply to income related to noninsurance activities. A small company is one the assets of which (computed on the basis of an affiliated group including both insurance and noninsurance members) are less than $500 million.

e. Rate reduction

All life insurance companies are allowed a deduction equal to 25 percent of their otherwise taxable income. This deduction is computed on the basis of a controlled group and does not apply to income related to noninsurance activities.

f. Tax-exempt income

Under present law, liabilities to policyholders are treated as funded proportionately out of taxable and tax-exempt income. The bill generally continues this approach.

g. Reinsurance

The provision under which the Treasury is granted authority to reallocate income, deductions, assets, reserves, credits, and other items in the case of related party reinsurance contracts is retained and broadened in its application.

h. Definition of a life insurance company

For purposes of determining whether a company qualifies as a life insurance company, funds held with respect to contracts that do not involve permanent purchase rate guarantees are not to be treated as insurance reserves.

i Effective date

Generally, the effective date for provisions dealing with the taxation of life insurance companies is January 1, 1984. Income that would otherwise result from recomputation of reserves (including section 818(c) recomputations and statutory-to-tax recomputations) and the change in accounting for policyholder dividends at the beginning of 1984 is forgiven under the bill .

The amount of deferred gain from operations held in the policyholder surplus account of the company (the Phase III account) would be frozen at its 1983 year-end level and distributions from such account would be taxed when distributed under the present law rules, which are retained.

2. Life insurance products

a. Definition of life insurance

Present law does not contain a definition of life insurance or of a life insurance contract. It does, however, contain temporary rules for purposes of determining whether benefits paid under certain flexible premium products qualify as life insurance benefits exempt from income tax. The bill adopts a definition that is based on the temporary rules contained in present law. A contract is treated as a life insurance contract if it meets (1) a "cash value accumulation" test, or (2) a "guideline premium" test and "cash value corridor" test. Under the cash value accumulation test a contract qualifies if the cash value accumulated under the contract does not exceed the cash value which would arise in a traditional whole life policy assuming a reasonable interest rate is used in computing cash value. Under the guideline premium limitation, contracts are disqualified if the amount of the policyholder's investment in the contract exceeds a traditional level of investment. The cash value corridor disqualifies contracts which build up excessive amounts of cash value relative to life insurance risk. Special transitional rules apply to existing contracts and contracts that may be issued in 1984.

For contracts that fail to meet the definition at any time, the pure insurance portion of the contract (i.e., the difference between the face amount and the cash surrender value) will be treated as term life insurance. The cash surrender value will be treated as a deposit fund and income earned on the fund will be taxed currently.

b. Annuities

Under the bill, the present law exception from the 5-percent penalty for distributions of income allocable to investments within 10 years is repealed. Thus, the penalty generally will apply to distributions prior to age 59½. In addition, if the owner of a deferred annuity dies prior to annuitization, the income in the annuity will be included in the decedent's last income tax return.

c. Group-term life insurance

The antidiscrimination rules and the limitation on the exclusion from income of premiums for group-term benefits are extended to retired employees. These rules would not apply to coverage in place under existing group plans on September 27, 1983.

d. Policyholder loans

Under the bill, the deduction for interest paid on policy loans is limited. The limitation for an individual is $250,000 ($500,000 for a joint return) multiplied by the deficiency interest rate. For businesses, the limitation is the aggregate of $500,000 per individual policy times the deficiency interest rate. The bill contains carryover rules for unused deduction limitation. The new rules generally are effective for policies issued after September 27, 1983.

3. Nondeductible contributions to individual retirement plans

Under present law, an individual generally is entitled to deduct the amount contributed to an individual retirement account or annuity or used to purchase retirement bonds (IRAs). The maximum amount that can be contributed is limited. Except for tax-free rollovers, no nondeductible contributions may be made to an IRA. An annual 6-percent excise tax applies to prohibited nondeductible contributions (i.e., excess contributions) held in an IRA. Under the provision, certain nondeductible IRA contributions (up to the nondeductible limit) are not treated as excess contributions subject to the six percent annual excise tax. The nondeductible limit may not exceed $1,750.

The provision is effective for taxable years beginning after December 31, 1983.

Title III.—Revision of Private Foundation Provisions

1. Charitable deduction rules

Under present law, contributions by individuals of cash or property to private nonoperating foundations (and certain other charitable organizations) generally are deductible up to 20 percent of the donor's adjusted gross income (Code sec. 170(b)(1)(B)). The bill raises this limitation to 30 percent for gifts of cash and ordinary-income property, but retains the 20-percent limitation for all gifts of capital-gain property.

The bill also provides that contributions to private nonoperating foundations of certain appreciated stock are deductible at the stock's fair market value (rather than at the present-law limitation of the donor's basis plus 60 percent of the appreciation). The increased deduction applies only to the extent that the cumulative total of donations by a donor (and family members) to private nonoperating foundations of stock in a particular corporation is less than 10 percent of the value of all outstanding stock of that corporation.

In addition, the bill extends to private nonoperating foundations the same rules on carryovers of charitable contributions exceeding the percentage limitations as apply under present law for contributions by individuals to public charities and private operating foundations (sec. 170(d)).

These changes made by the bill apply to contributions made after 1984. The increased deduction for contributions of certain appreciated stock will not apply to contributions made after 1994.

2. Excise tax on investment income

The bill reduces from two to one percent the rate of the excise tax on net investment income of private foundations (sec. 4940), effective for post-1984 taxable years, but only if the foundation's payout for charitable purposes (computed as a five-year average) is increased by an equivalent amount.

Also, the bill exempts from the section 4940 excise tax any private operating foundation that previously had been publicly supported for at least 10 years (or was in existence on January 1, 1983), that has a governing body broadly representative of the general public (with at least 75 percent consisting of persons unrelated to the foundation), and none of whose officers otherwise are disqualified persons. This amendment applies to post-1984 taxable years.

3. Mandatory payout rules

The bill limits the amount of grant administrative expenses which may be counted as qualifying distributions for purposes of meeting the minimum payout requirement (sec. 4942), effective for post-1984 taxable years, to 15 percent of the amount of grants, gifts, and contributions made by the foundation, computed on the basis of a five-year average. The limitation does not apply to administrative expenses incurred directly for the active conduct of an exempt activity.

4. Divestiture of excess business holdings

The bill generally retains the divestiture rules of present law (sec. 4943) with respect to "grandfathered" excess business holdings which were held by private foundations on May 26, 1969, with certain modifications.

In the case of an unusually large gift or bequest after 1969 of diverse or complex excess business holdings, the bill provides the Internal Revenue Service with discretionary authority to permit an additional five-year period for divestiture on a showing by the foundation of good cause plus diligent efforts to dispose of the holdings within the five-year period permitted under present law.

5. Expenditure responsibility and reliance rules

The bill exempts from the expenditure responsibility requirements imposed on foundation grantors (sec. 4945) grants to those private operating foundations which the bill exempts from the two-percent excise tax on net investment income (see above), effective for post-1984 grants.

The Treasury Department is to review its expenditure responsibility regulations for purposes of modifying requirements which are found to be unduly burdensome or unnecessary. Also, Treasury regulations are to be amended to extend to five years the advance ruling period during which qualifying new organizations are considered public charities, and to permit greater reliance on IRS classifications of new charitable organizations in the first five years of their existence.

6. Foundation support for voter registration drives

The bill retains all requirements of present law limiting private foundation support for voter registration drives (sec. 4945(f)) except the requirement that the voter registration drive must be conducted in five or more States; the latter requirement is repealed effective January 1, 1984. As under present law, the registration drive must be nonpartisan, and cannot be confined to one election period.

7. Abatement of first-tier penalty taxes

The bill provides the Internal Revenue Service with discretionary authority to abate the automatic first-tier penalty taxes (other than the sec. 4941 tax on self-dealing) if the foundation establishes that the violation was due to reasonable cause and not to willful neglect, and corrects the violation. This provision applies to taxable events occurring after 1984.

8. Definitions

The bill provides that the lineal descendants who are considered members of the family of a substantial contributor or other disqualified person, and thus themselves are considered to be disqualified persons (sec. 4946), are limited to the individual's children, grandchildren, great-grandchildren, and their spouses, effective January 1, 1985.

In addition, the bill provides rules under which a person's status as a substantial contributor (sec. 507(d)) terminates in certain circumstances after 10 years with no connection to the foundation, effective for post-1984 taxable years. Also, the bill provides special retroactive relief from the excise tax on self-dealing in a particular case where continued status as a disqualified person had triggered tax on a 1978 transaction, provided that the foundation received fair market value.

9. Public disclosure requirements

The bill provides that, beginning in 1985, private foundation notices which must be published annually in a newspaper (sec. 6104(d)) are to include the telephone number of the foundation's principal office. Also, the Internal Revenue Service is directed to enforce fully the present-law rules concerning Form 990-PF information returns.

10. Games of chance

The bill exempts from the unrelated business income tax (sec. 513) income derived by nonprofit organizations from conducting certain games of chance, provided that State or local law as of October 5, 1983, permits such games to be conducted only by nonprofit organizations. This provision applies retroactively to games of chance conducted after June 30, 1981.

Title IV.—Tax Simplification Provisions

1. Estimated income tax for individuals

The individual estimated income tax rules of present law are simplified and clarified by the bill. Generally, an individual will be required to make estimated tax payments (including withholding payments) equal to the lesser of 80 percent of the current year's tax or 100 percent of the prior year's tax; penalties will be based on the underpayment from this amount. Payments based on annualized income will be allowed. The Secretary may waive the penalty for failure to make payments by reason of a casualty, disaster or other unusual circumstance where it would be inequitable to impose the penalty. Estimated tax payments of the alternative minimum tax will be required.

The provision will be effective for taxable years beginning after 1984.

2. Domestic relations

a. Transfers of property between spouses or incident to divorce

Under present law, gain is recognized on certain transfers of property in exchange for marital rights of a spouse or former spouse. The bill provides that property transfers between spouses or, if incident to divorce, between former spouses, will not result in the recognition of gain or loss. The transferee will hold the property at the transferor's basis. Also, investment tax credits will not be recaptured.

The provision will generally be effective for transfers after the date of enactment of the bill. The bill also allows taxpayers to elect to have this provision apply to transfers after December 31, 1983, or to transfers on or before the date of enactment.

b. Alimony

Under present law, alimony is deductible by the payor and includible in the income of the payee. The bill revises the rules relating to the definition of alimony. Generally, only cash payments that will terminate on the death of the payee spouse will qualify as alimony. The present law requirement that the payment be based on a legal support obligation will be repealed. Payors will be required to furnish to the IRS the social security number of the payee spouse. A $50 penalty for failure to do so will be imposed.

The provision will generally be effective for divorce or separation agreements or orders executed after 1984.

c. Dependency exemption

The bill provides that the $1,000 dependency exemption for a child of divorced or separated parents generally will be allocated to the custodial parent unless the custodial parent signs a written declaration that he or she will not claim the exemption for the year. Each parent may claim the medical expenses that he or she pays for the child, for purposes of computing the medical deduction.

Income from certain sheltered workshops will not be taken into account in determining the dependency exemption.

The provision will be effective for taxable years beginning after 1984.

d. Innocent spouse relieved of liability in certain cases

Under present law, a spouse may be relieved of liability where he or she signs a joint return and there was a substantial omission of income attributable to the other spouse. The bill extends these rules to situations involving claims of grossly erroneous deductions and credits and would replace the substantial omission of income test with a substantial understatement of tax test. Also, the bill overrides community property laws in certain situations where it is equitable to do so.

e. Gift and estate tax treatment of certain property settlements

The bill conforms the estate tax treatment with respect to transfers of property to a former spouse under certain property settlements with the present law allowing a gift tax exemption for such transfers. The bill also extends the period to enter into a property settlement agreement in order to avoid gift tax. The provision will apply to gifts made and to estates of decedents dying after date of enactment of the bill.

3. At-risk rules

The bill amends the at-risk limitation on the investment tax credit by providing that the base for the credit will be reduced by nonrecourse indebtedness related to the property (i.e., a loan on which there is no personal liability). Qualified commercial financing, defined as financing from an unrelated party regularly engaged in commercial lending where no more than 80 percent of all financing for the property is nonrecourse, will be excluded from the limitation. In the case of an S corporation, recourse financing at the corporate level that is provided by a qualified commercial lender will be considered recourse financing at the shareholder level if the debt is related to property used by the corporation in an active trade or business with at least 3 full-time non-owner employees.

The bill will exempt, from both the loss limitation rules of section 465 and the investment tax credit at-risk rules, the active trade or business activities of a regular closely held business corporation. To qualify, a trade or business must have 3 full-time non-owner employees and its out-of-pocket expenses must exceed 15 percent of gross income. Non-closely held corporations will continue to be exempt from the at-risk rules.

The bill also requires that, for a lessee to be eligible to claim the full investment tax credit, the lessee must be at risk for rental payments the present value of which is equal to at least 30 percent of the fair market value of the property.

The investment tax credit provisions generally will generally apply to property placed in service in taxable years ending after the date of enactment of the bill. At the taxpayer's election, these provisions will apply as if included in the Economic Recovery Tax Act of 1981. The changes to the general at-risk rules will apply to taxable years beginning after December 31, 1983.

4. Estate tax revisions

a. Permanent rules for reforming governing instruments creating charitable remainder trusts and other charitable interests

Under the rules adopted by the Tax Reform Act of 1969, a charitable interest in a split-interest trust (i.e., a trust which is part charitable and part noncharitable) must be in certain specified forms to be deductible for Federal income, gift, and estate tax purposes. Present law permits defective governing instruments of charitable split-interest trusts which were created pursuant to wills executed before January 1, 1979, to be amended to conform to the 1969 Act rules by December 31, 1981.

The bill provides a permanent rule permitting reformation of governing instruments of charitable split-interest trusts which do not meet the requirements of the 1969 Act rules where the instrument evidences an intent to comply with the 1969 Act rules (or the reformation begins within a specified period) and the actuarial values and durations of the charitable and noncharitable interests in the trust generally remain the same before and after the reformation.

This provision will be effective with respect to reformations made after December 31, 1978.

b. Alternate valuation date election

Under present law, the value of property includible in the decedent's gross estate for Federal estate tax purposes generally is determined on the date of the decedent's death. However, the executor of the decedent's estate may elect to have the value of all property included in the gross estate determined as of the alternate valuation date (which generally is six months after the decedent's death). The election to use the alternate valuation date may be made only on a timely filed Federal estate tax return. Also, under present law, the Federal income tax basis of property acquired from a decedent generally is its value for Federal estate tax purposes.

The bill provides that the election to use the alternate valuation date may be made only where both the total value of all property in the gross estate and the Federal estate tax liability of the estate are reduced by making the election. The bill would also allow the alternate valuation election to be made on the first estate tax return filed (whether filed timely or late).

This provision will be effective with respect to estates of decedents dying after the date of enactment of the bill.

5. Foreign tax provisions

a. Resident aliens

The bill makes several changes in the tax provisions affecting foreign income and foreign taxpayers. It provides standards for determining whether an alien individual is a resident of the United States. Under these standards, an individual who spends substantial time in the United States in any year or over a three-year period will generally be a U.S. resident. A permanent resident for immigration purposes will be a U.S. resident, also. The bill prevents married nonresident aliens from using the community property laws of their home country to split income for U.S. tax purposes. These provisions are generally effective for taxable yars beginning after 1984.

b. Foreign personal holding company attribution rules

The bill clarifies the family attribution rules for determining when a foreign corporation is a foreign personal holding company. It also prevents avoidance of U.S. tax by interposition of a foreign trust or another foreign entity between a foreign personal holding company and a U.S. taxpayer. These provisions generally apply to taxable years beginning after 1983.

c. Ordinary income treatment under section 1248

The bill clarifies the rules that tax the previously untaxed earnings and profits of a controlled foreign corporation at ordinary income rates when its U.S. owner disposes of the shares or liquidates the corporation. It prevents later double taxation of those earnings and profits and double crediting of associated foreign taxes. It also treats direct ownership of a controlled foreign corporation like indirect ownership for the purpose of these rules. These provisions are generally effective for transactions occurring after the date of enactment.

d. Coordination of subpart F with foreign personal holding company provisions

The bill coordinates the foreign personal holding company rules with the controlled foreign corporation rules. It provides that shareholders of a controlled foreign corporation (that is also a foreign personal holding company) are subject to the controlled foreign corporation rules to the extent that income taxable under those rules exceeds income taxable under the foreign personal holding company rules. This provision applies to taxable years beginning after the date of enactment.

e. Stapled stock

The bill contains provisions regarding so-called stapled stock. It provides generally that if a foreign and a domestic corporation are stapled entities, the foreign corporation generally will be treated as domestic. In addition, if two domestic corporations are stapled entities, each will be treated as owning the other. These provisions are generally effective on the date of enactment.

6. Miscellaneous Treasury administrative provisions

The bill makes a number of minor amendments relating to Treasury administrative provisions. The bill simplifies certain requirements of the Treasury Department to make reports to the Congress, removes the $1 million limitation of the Treasury working capital fund, increases the authorization limit from $1 million to $10 million on the revolving fund for the redemption of real property, allows the Secretary of the Treasury to accept gifts and bequests for the Treasury Department, allows an extension of time for court review of a jeopardy assessment where the government is not promptly served, removes the $1 million limitation on the Secretary of the Treasury's special authority to dispose of obligations, allows the Internal Revenue Service a minimum of 60 days to assess unpaid taxes shown on an amended return, provides the government a lien on the assets of all financial institutions which issue an unpaid guaranteed draft for the payment of taxes, and allows the disclosure of windfall profit tax returns to State tax agencies.

The bill also repeals the occupational tax on manufacturers of stills and condensors, allows drawback claims for distilled spirits excise taxes in certain cases, provides for disclosure of alcohol fuel producers to administrators of State alcohol laws, and repeals the stamp requirement for distilled spirits containers.

7. Tax Court provisions

The bill allows certified public accountants and enrolled agents authorized to practice before the Internal Revenue Service to represent taxpayers in small claim cases before the Tax Court and increases the small claims case dollar limit from $5,000 to $10,000. The title of the Tax Court "commissioners" will be changed to "special trial judges". The bill provides that the Tax Court may prevent public disclosure of trade secrets or other confidential information. Finally, Tax Court judges will no longer be required to retire at age 70.

8. Simplification of income tax credits

In general, the bill groups existing income tax credits into logical categories and provides uniform tax liability limitations and carryover rules. The business credits (i.e., investment tax credit, targeted jobs credit, alcohol fuels credit, and ESOP credit) will be combined into one credit and allowed up to 100 percent of the first $25,000 of tax liability and 85 percent of the remainder. The research credit will continue to be allowable against 100 percent of tax liability. A 3-year carryback and 15-year carryforward period on a FIFO basis will be allowed for the business credits.

This provision will apply to taxable years beginning after 1983.

9. Miscellaneous tax provisions

a. Rollover of certain partial distributions from qualified plans

Under the bill, distributions of less than the balance to the credit of an employee under a qualified pension, profit sharing, or stock bonus plan or a tax-sheltered annuity contract can be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution will be permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment as prescribed by the Secretary of the Treasury.

The provision will be effective for distributions made after the date of enactment of the bill, in taxable years ending after that date.

b. Treatment of certain related party transactions

The bill amends the related party rules (sec. 267) so that a taxpayer would generally be placed on the cash method of accounting for purposes of deducting business expenses and interest owed to a related party cash basis taxpayer. These rules will be extended to amounts accrued by a partnership to its partners and vice versa.

Also, the bill extends the loss disallowance and accrual provisions to transactions between corporations which are members of a controlled group of corporations, using a 50-percent control test. This provision will not apply to transactions with a controlled DISC.

These provisions generally will apply to taxable years beginning after 1983. However, the provision will not apply to (1) interest on indebtedness incurred on or before September 29, 1983, or incurred pursuant to a contract binding on that date and all times thereafter and (2) other expenses made pursuant to a contract which was binding on September 29, 1983, and at all times thereafter.

c. Preferred stock eligible for small business corporation stock treatment

Under present law, a taxpayer is allowed to deduct, as an ordinary loss, up to $50,000 ($100,000 in the case of a joint return) of loss on the disposition of certain common stock of a domestic small business corporation. The bill, which applies to stock issued after the date of enactment, extends ordinary loss treatment to preferred stock of qualified small business corporations.

d. Medical expense deduction for certain lodging

Under present law, individuals who itemize deductions may deduct certain expenses paid for medical care to the extent the expenses exceed 5 percent of adjusted gross income. Amounts paid for transportation primarily for and essential to medical care are treated as expenses paid for medical care. Amounts paid for lodging while away from home, however, do not qualify for the deduction.

Under the bill, certain expenses for lodging while away from home to receive medical care as an outpatient at a hospital or certain similar medical care facilities are treated as expenses paid for medical care, up to a limit of $50 per eligible person per day. This provision is effective for taxable years beginning after 1983.

e. Study of gross income tax

The bill provides for a study by the Treasury Department of a simplified gross income tax, to be submitted to the Congress within 6 months after date of enactment of the bill.

10. Repeal of certain obsolete provisions (deadwood)

Three provisions (Code sections 405, 409, and 1251) are repealed as deadwood.

Title V.—Fringe Benefit Provisions

The Code defines gross income for income tax purposes as including "all income from whatever source derived" and specifies that it includes "compensation for services" (sec. 61). Similarly, the social security and unemployment insurance payroll taxes (FICA and FUTA) and income tax withholding generally apply to all remuneration for employment, including noncash remuneration.

Under present law, specific statutory exclusions are provided for income and employment tax purposes for certain types of employee benefits, such as health benefits. However, the Economic Recovery Tax Act of 1981 (P.L. 97-34) extended through December 31, 1983, a moratorium on the issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits.

Under the bill, certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes and from the wage and benefit base for purposes of social security and other employment taxes. The excluded fringe benefits are those that qualify under one of the following five categories as defined in the bill: (1) a no-additional-cost service, (2) a qualified employee discount, (3) a working condition fringe, (4) a de minimis fringe, or (5) a qualified tuition reduction. Special rules apply with respect to certain parking or eating facilities provided to employees, on-premises athletic facilities, and demonstration use of an employer-provided car by auto salespersons.

In the case of a no-additional-cost service, a qualified employee discount, employee parking, a subsidized eating facility, or a qualified tuition reduction, the exclusion applies with respect to benefits provided to officers, owners, or highly compensated employees only if the benefits are also made available to other employees on a nondiscriminatory basis.

Any fringe benefit that does not qualify for exclusion under the bill or under another specific statutory provision is includible in gross income, and subject to employment taxes, at the excess of its fair market value over any amount paid by the employee for the benefit.

The provisions of the bill generally take effect on January 1, 1984, except that the tuition reduction exclusion applies with respect to education furnished after June 30, 1984.

Title VI.—Technical Corrections

This title contains technical, clerical, conforming and clarifying amendments to provisions enacted by the Tax Equity and Fiscal Responsibility Act of 1982, the Subchapter S Revision Act of 1982, the Highway Revenue Act of 1982, the Social Security Amendments of 1983 and other recently enacted tax legislation.

Title VII.—Tax-Exempt Bond Provisions

1. Mortgage subsidy bonds

a. Extension of qualified mortgage bond authority

The bill extends the tax exemption for qualified mortgage bonds to bonds issued prior to January 1, 1989. State mortgage bond volume caps are to be reduced, in any year, by the volume of qualified veterans' mortgage bonds issued in the prior year. (An exception is provided for veterans' mortgage bonds issued pursuant to certain authorizations made prior to 1984.) Veterans' mortgage bonds are also to be subject to the January 1, 1989, sunset date. Additionally, the bill makes mortgage subsidy bonds (including veterans' mortgage bonds) subject to a reporting requirement.

b. Mortgage credit certificates

The bill allows State and local governments, for any year, to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs will entitle homeowners to credits not exceeding 50 percent (but not less than 10 percent) of interest on indebtedness incurred with respect to qualifying residences. The credits are to be subject to the existing eligibility requirements for qualified mortgage bonds. Credits not usable in any year by a homeowner may be carried over against a later year's tax liability.

Under the bill, the amount of MCCs distributable by a State or local government is equal to 15 percent of the principal amount of exchanged mortgage subsidy bond authority. The amount of exchanged authority cannot exceed 9 percent of the average volume of single-family mortgages in the State during the prior three years. For States and localities which issued less than their statutory ceiling of qualified mortgage bonds in 1983, a 5-year phase-in of MCC authority is to apply.

MCCs are subject to the January 1, 1989, sunset for qualified mortgage bonds.

2. Limited equity cooperatives

The bill provides that limited equity housing cooperatives may elect to be eligible for either mortgage subsidy bond or industrial development bond (IDB) financing. If a cooperative elects to be eligible for IDB financing, the members of the cooperative may not receive deductions for interest and taxes on the property.

3. Industrial development bonds

a. Volume caps on private activity bonds

Under the bill, private activity tax-exempt bonds are subject to statewide volume caps. The caps are applicable to certain industrial development bonds (IDBs) and student loan bonds issued within the State. Bonds used to finance projects for multifamily residential rental property are exempted from the caps. Additionally, IDBs used to finance convention or trade show facilities, airports, docks, wharves, and certain mass commuting facilities are exempted from the caps where the facilities are owned for tax purposes by a State or local governmental unit.

The caps are to be set at $150 for each resident of the State (according to the most recent census estimates). The amount of the caps will be reduced to $100 per capita after 1986 to reflect the sunset for small issue IDBs. Within each State, the cap is to be allocated among State and local issuers according to rules similar to those used for allocation of mortgage subsidy bond authority.

The bill provides for a three-year carryover (six years in the case of pollution control bonds) of a State's volume cap to finance specific projects or for student loan bonds. The carryover is not applicable for small issue IDBs. Additionally, for States whose 1983 volume exceeds the statewide cap, a two-year phase-in is applicable.

b. Restrictions on cost-recovery for IDB-financed property

The bill repeals three of the four present law exceptions to the rule requiring straight-line cost recovery deductions (over ACRS periods) for IDB-financed property. However, the bill allows projects for multifamily residential rental property to continue to receive full accelerated cost recovery over ACRS periods.

c. Limitations on IDBs for land or existing facilities

The bill eliminates the use of IDBs to purchase agricultural land or existing facilities in most cases. Exceptions are provided for substantial rehabilitations and up to $250,000 of IDB financing for first-time farmers or ranchers. Use of IDB proceeds to purchase land for nonagricultural purposes is limited to 25 percent of bond proceeds.

d. Restrictions on small issue IDBs

The bill allows small issue IDBs only to the extent that not more than $40 million in IDB financing is outstanding for each beneficiary of the small issue.

Under the bill, the capital expenditure limits applicable to small issue IDBs are to be applied to an entire project rather than to individual users (as under present law). For example, a multi-story office building is to be treated as a single project and the limitations applied to the entire building.

The bill increases from $20 million to $25 million the size of projects receiving Urban Development Action Grants (UDAGs) which qualify for small issue IDB financing.

e. Federally guaranteed bonds

The bill denies a tax exemption for obligations guaranteed directly or indirectly by the Federal Government, including bonds issued in connection with Federal deposit insurance. Exceptions are provided for guarantees by various housing-related agencies and student loan guarantees, and for guarantees of pollution control bonds by the Small Business Administration. Bonds used to finance multifamily residential rental property are exempt from the Federal guarantee rule.

f. Non-Code tax exemptions

The bill requires bonds issued pursuant to tax exemptions outside the Internal Revenue Code (including bonds issued by U.S. possessions) to meet the requirements of the tax-exempt bond provisions of the Code, including the volume limitation and other restrictions applicable to industrial development bonds.

g. Arbitrage

The bill extends the arbitrage rules applicable under present law to mortgage subsidy bonds to all private activity bonds other than bonds used to finance multifamily residential rental property.

h. Advance refundings

The bill eliminates the rule allowing advance refundings of bonds used to finance certain convention and trade show facilities, airports, docks, wharves, mass commuting facilities and parking facilities.

i. Further tax-exempt bond provisions

The bill denies tax exemption where bonds are used by a principal user of the facility being financed or a partner of the principal user. The bill permits IDB financing for the multifamily residential rental property portion of a mixed-use project. The bill prohibits the use of IDBs to finance liquor stores, sky boxes, private airplanes, and gambling establishments. Further, under the bill, the public approval requirements for private activity bonds are modified in the case of certain airports located in more than one jurisdiction. The bill provides a tax exemption for obligations issued by the Pennsylvania State University and makes certain other changes in the rules regarding IDBs.

4. Effective dates

The provisions regarding mortgage subsidy bonds and industrial development bonds are generally effective for obligations issued after December 31, 1983. In the case of bonds issued in connection with Federal deposit insurance, the denial of tax exemption applies to obligations issued after April 14, 1983. The bill provides appropriate transition rules for purposes of certain of the limitations on industrial development bonds.

Title VIII.—Miscellaneous Revenue Matters

1. Capital gain treatment for portion of gain on sale of condominium units converted from existing structures

Under present law, the entire gain on the conversion of property into condominiums and the individual sale of those condominiums generally is treated as ordinary income to the seller. As a result, owners of property who wish to convert it into condominiums often sell the entire property to another person who converts the property and sells the individual condominium units. If the entire property is sold in one sale prior to conversion, the owner generally will receive capital gain treatment with respect to the gain on the sale of the property.

In general, the bill provides that a taxpayer can elect to treat a portion of the gain realized on the sale or exchange of the condominium units acquired in the conversion of qualified real property into condominium units as capital gain. The amount treated as capital gain will be the excess of the fair market value of the property over the property's adjusted basis at the time of the conversion. Any additional gain on the disposition of the units will be treated as ordinary income. The provision will apply to conversions after the date of enactment of the bill in taxable years ending after such date.

2. No gain recognized from net gifts made before March 4, 1981

Present law taxes income "from whatever source derived," including the benefit resulting from the discharge of one's indebtedness by another party (Code sec. 61(a)(12)). Present law also imposes a gift tax on certain transfers for less than adequate consideration (sec. 2501). Liability for the gift tax is on the donor of the transferred property.

A donor may transfer property pursuant to an agreement with the donee that the donee will pay any gift tax arising from the transfer (i.e., make a "net gift"). On June 15, 1982, the U.S. Supreme Court ruled in *Diedrich* v. *Commissioner*, that the discharge of a donor's liability for gift tax by the donee of a net gift gives rise to income to the donor to the extent that the gift taxes exceeded the donor's adjusted basis in the transferred property.

The bill would provide that no income would be recognized to donors who made net gifts before March 4, 1981 (the date on which an initial decision by the Court of Appeals held that the donor in the *Diedrich* case recognized income).

3. Disaster loss deduction where taxpayer ordered to demolish or relocate residence in disaster area because of disaster

Present law allows a deduction for nonbusiness casualty losses to the extent such losses exceed $100 per loss and 10 percent of adjusted gross income for the taxable year. In general, a deduction is allowed only when the casualty (e.g., storm, flood or earthquake) causes actual physical damage to the taxpayer's property.

The bill provides that certain taxpayers whose residences are located in a Federally declared disaster area, and who are ordered by a State or local government to demolish or relocate their residences, may deduct any loss attributable to the demolition or evacuation order as a casualty loss. The provision applies to taxpayers whose residences have been rendered unsafe for use as a residence as a proximate result of the disaster. This provision is retroactive to January 1, 1982.

4. Foreign investment companies

a. Offshore commodity funds

Under present law, taxpayers contend that a foreign corporation that is widely held by U.S. persons may establish a subsidiary to invest in U.S. commodities markets without any of the parties incurring U.S. tax. They also contend that when the U.S. shareholders eventually dispose of their shares in the foreign corporation they will be subject to tax at only the capital gains rate. This provision applies generally to sales or exchanges on or after September 29, 1983.

The bill will, in certain cases, apply the accumulated earnings tax to earnings from U.S. investments, even after those earnings pass through corporate solution as dividends or interest. It will also generally treat gains of U.S. shareholders from those investments as ordinary income. This provision applies generally to distributions received on or after May 23, 1983.

b. Corporations formed to straddle

Taxpayers may attempt to avoid the tax straddle rules by forming corporations, typically foreign corporations, to take positions to offset their own. The bill will treat such stock ownership as a position for the purposes of the straddle rules. This treatment will prevent a taxpayer from recognizing losses when the taxpayer uses a corporation for straddling purposes. This provision applies to positions established on or after May 23, 1983.

5. Application of cash or deferred arrangement rules to pre-ERISA money purchase plans

The Employee Retirement Income Security Act of 1974 (ERISA) provided that amounts deferred by an employee pursuant to a cash or deferred arrangement or a salary reduction arrangement under a tax-qualified profit-sharing, stock bonus, or money purchase pension plan are excluded from the employee's income if (1) the plan was in existence on June 27, 1974, and (2) the applicable requirements of prior law were satisfied. This tax treatment for then existing plans was preserved, pending study by the Congress of the appropriate treatment for cash or deferred and salary reduction arrangements.

Under the Revenue Act of 1978, amounts deferred by an employee after 1979 pursuant to a cash or deferred arrangement under a tax-qualified profit-sharing or stock bonus plan are excluded from the employee's income only if certain requirements added by the Act are met. No new rules were provided by the 1978 Act for salary reduction arrangements under money purchase pension plans.

Under the bill, amounts deferred by an employee pursuant to a salary reduction arrangement under a money purchase pension plan are excluded from the employee's income if the plan was in existence on June 27, 1974, and contributions by employees and the employer do not exceed the levels permitted under the plan's contribution formula on that date. In addition, the plan must satisfy rules added by the 1978 Revenue Act with respect to employee participation and prohibited discrimination in favor of officers, shareholders, or highly compensated employees.

The bill will apply to plan years beginning after the date of enactment. The rules in effect prior to ERISA will apply for plan years beginning after December 31, 1979, and before the date of enactment.

6. Extension of PIK rules to 1984 wheat program

Present law provides special tax treatment for commodities received by a producer under a 1983 PIK program for withdrawing land from production. Under these rules, producers may defer recognition of income on PIK commodities until the commodities are sold; PIK participants are not disqualified from various special tax provisions available to taxpayers engaged in the business of farming; and the applicability of income income, employment and estate tax provisions is not affected solely as a result of a taxpayer's participation in the PIK program. The bill generally extends these special PIK tax rules to the 1984 wheat program.

7. Unemployment compensation for pre-1978 periods

The bill amends the Revenue Act of 1978 to provide that the provisions of that statute which make includible in income a portion of unemployment compensation benefits apply to payments of unemployment compensation made after 1978 except payments for weeks of unemployment ending before December 1, 1978. The bill also extends until one year after enactment the period for claiming any credit or refund attributable to this amendment.

8. Traveling expenses at Nekoma ABM site

Under the bill, traveling expenses in connection with employment at the Nekoma, North Dakota, antiballistic missile project are deductible if (1) the expenses are otherwise deductible as business expenses; (2) the expenses were paid or incurred after 1969 and before 1975; and (3) the expenses were claimed on a tax return filed for any taxable year which includes any portion of the period described in (2). In addition, the bill extends the period of limitations for obtaining refunds due as a result of the provisions of the bill.

9. Retirement plans for airline pilots

Present law imposes limits on contributions and benefits under tax-qualified pension plans. Under these limits, the annual benefit payable under a defined benefit plan generally cannot exceed

$90,000 for 1984. The $90,000 limit is reduced if a benefit is payable before age 62. Under the bill, in the case of commercial airline pilots who are required, under Federal regulations, to retire at age 60, the limits on benefits under qualified defined benefit pension plans will not be reduced for early retirement at age 60.

10. Treatment of tip income under FUTA

The bill provides that all tip income accounted for by an employee to an employer will be treated as taxable wages for purposes of the Federal Unemployment Tax Act (FUTA).

11. Taxation of regulated investment companies

a. Stock ownership of regulated investment companies

Under present law, a regulated investment company (RIC) is treated, in essence, as conduit for tax purposes. If a corporation is a RIC, it is allowed a deduction for dividends paid to its shareholders. One of the requirements that a corporation must meet in order to be a RIC is that it cannot be a personal holding company.

The bill modifies the definition of a regulated investment company (RIC) to permit a personal holding company (PHC) to qualify as a RIC. In the case of a RIC which is a PHC, any undistributed investment company taxable income of the RIC will be at the highest corporate rate.

The committee bill would allow a RIC to elect to include discount income on short-term government securities as it accrues. This provision is effective for taxable years beginning after 1978.

12. Installment payment of estate tax attributable to closely held corporations

The bill amends the estate tax installment payment provision to permit consideration of the value of certain active business stock owned indirectly through ownership of an interest in a passive holding company in determining whether an estate qualifies for installment payments. The special 4-percent interest rate and 5-year deferral of principal payments will not apply to estates electing this provision.

13. Cooking wine

The bill expands the circumstances in which distilled spirits can be withdrawn from bond without payment of tax to permit tax-free withdrawal of such spirits for use in production of nonbeverage wines (e.g., cooking wine).

14. Nonprofit dependent care organizations

The bill provides that nonprofit day care centers qualify for tax-exempt status (under sec. 501(c)(3)), and eligibility to receive tax-deductible contributions, if both (1) substantially all of the dependent care provided to children by the organization is for the purpose of enabling individuals to be gainfully employed, and (2) the services provided by the organization are available to the general public. This provision is effective for taxable years beginning after the date of enactment.

15. Home for handicapped person won as prize

The bill provides that no interest or penalties will be payable on the Federal income tax liability attributable to receipt of a residence won as a prize, and specially designed for a handicapped foster child of the taxpayer, where certain conditions apply, but only if the tax liability is paid within one year after the date of enactment.

Title IX.—Social Security Disability Benefits

1. Standards of disability

a. Standard of review for terminations of disability benefits (medical improvement)

Section 901 of the bill requires the continuation of benefits for those individuals whose conditions have not medically improved to the point of ability to perform SGA, with the following exceptions:

(1) benefits may be terminated if new evidence shows the beneficiary has benefited from advances in medical therapy or technology or from any vocational therapy to the point of ability to perform SGA; and

(2) benefits may be terminated if new evidence (including new diagnostic or evaluation techniques not available or used at the original determination) shows the impairment or impairments to be less severe than originally thought.

Section 901 also provides for termination of benefits whether or not the impairment has improved if the person is currently working at the substantial gainful activity (SGA) level, or if the prior determination of entitlement to benefits was either clearly erroneous at the time it was made, or was fraudulently obtained. SSA would be authorized to secure additional medical evidence to reconstruct initial decisions in cases where there is no medical evidence supporting the initial decision.

b. Study on evaluation of pain

Section 902 requires the Secretary, in conjunction with the National Academy of Sciences, to conduct a study concerning the questions of using subjective evidence of pain in determining whether a person is under a disability, and the state of the art of preventing, reducing or coping with pain. A report is to be submitted to the Committee on Ways and means and the Senate Committee on Finance by April 1, 1985.

c. Multiple impairments

Section 903 provides that in determinations of disability, the Secretary must consider the combined effect of all of an individual's impairments whether or not each or any impairment would alone be severe enough to qualify the person for benefits.

2. Disability determination process

a. Temporary moratorium on mental impairment reviews

Section 904 provides for a temporary delay on reviews of all mental impairment disabilities until the listings for mental impairments have been revised in consultation with the Advisory Council, and are published in final form in regulations. Regulations must be published no later than nine months after the date of enactment. The delay also would be imposed on review of all CDI mental impairment cases after June 7, 1983.

b. Face-to-face evidentiary hearing

Section 905 provides for the implementation, no later than January 1, 1985, of face-to-face evidentiary interviews at the State agency level for medical termination cases. Under this provision, the State agency would send the beneficiary a preliminary notice of an unfavorable decision and the claimant would have 30 days in which to request a face-to-face meeting before a formal determination is made. The reconsideration level would be abolished for all initial CDI decisions completed after January 1, 1985.

Section 905 also requires the Secretary to initiate demonstration projects with respect to face-to-face evidentiary meetings at the initial level of State agency determination for new applicants and report to the Congress by April 1, 1985.

c. Payments of benefits during appeal

Section 906 provides on a permanent basis for the continuation of benefits during appeal in all CDI cases through the decision of the Administrative Law Judge. Where the ALJ's decision is adverse to the beneficiary, such benefit payments would be subject to recoupment as under present law. The provision also requires the Secretary to report to Congress on the impact of the provision by July 1, 1986.

d. Qualifications of medical professionals

Section 907 provides that no determination that a person is not under a disability be made with respect to mental impairments until a psychiatrist or psychologist employed by the State agency has completed the medical portion of the case review as well as the assessment of residual functional capacity.

e. Consultative examinations

Section 908 provides that regulations be promulgated regarding consultative examinations.

3. Miscellaneous provisions

a. Application of uniform standards for disability determinations

Section 909 provides that the notice and comment provisions of Section 553 of the Administrative Procedures Act would apply to benefit programs under Title II. The provision leaves in place the existing exceptions in Section 553 of the APA referring to the issuance of interpretive rulings, as well as purely administrative procedures.

b. SSA compliance with certain Federal court decisions

Section 910 requires SSA to either apply the decisions of circuit courts of appeal to at least all beneficiaries residing within States within the circuit, or appeal the decision to the Supreme Court. This provision applies to circuit court opinions issued after the date of enactment as well as to those opinions which the Secretary still has the opportunity to appeal to the Supreme Court as of the date of enactment.

c. Payment from trust funds for costs of rehabilitation services

Section 911 repeals the requirement in those cases where there is a medical recovery that a disabled beneficiary must perform 9 months of SGA to qualify the vocational rehabilitation provider for reimbursement. In addition, payment for services to VR providers would be authorized for beneficiaries who without good cause refuse to continue to accept services or fail to cooperate with the rehabilitation process.

d. Advisory Council on Medical Aspects of Disability

Section 912 creates an Advisory Council on Medical Aspects of Disability composed of independent medical and vocational experts to provide advice and recommendations to the Secretary on disability standards, policies and procedures. The Council would include 10 members to be appointed by the Secretary (with the Commissioner of Social Security an ex officio member) and must include at least one psychiatrist, one rehabilitation psychologist and one medical social worker.

The Council would be authorized to periodically convene a larger representative group to assure the input of appropriate professional and consumer organizations, and would also be authorized to set up temporary short-term task forces to examine some specialized issues.

Section 912 further provides that the Council must be appointed no later than 60 days after the enactment (to assure the timely participation of the Council in the review of the mental impairment listings) and would expire on December 31, 1985.

e. Staff attorneys

Section 913 requires the Secretary of HHS to establish higher grade attorney positions to enable staff attorneys to achieve qualifying experience necessary to be appointed to ALJ positions.

4. Effective date

Except as otherwise provided, these provisions will apply only with respect to cases involving disability determinations pending in HHS or in court on or after the date of enactment.

Title X.—Medicare Budget Reconciliation Amendments (Title X)

1. Payment and coverage—related changes

a. Payment for outpatient diagnostic laboratory tests

A fee schedule would be established for all clinical laboratory services provided to medicare beneficiaries except for hospital inpatients. The schedule may initially be established on a carrier or regional basis. A national fee schedule would be required to be established within three years.

The initial fee schedule would be set at a level no higher than 60 percent of prevailing charges and would be updated annually by the same percentage increase as the Consumer Price Index. The clinical laboratory would be required to bill the program directly and would be required to accept medicare assignment. For these services the laboratory would be reimbursed 100 percent of the fee schedule amount (or, if lower, the billed charge), with the deductible and coinsurance waived.

Where the physician directly provides, or supervises the provision of clinical laboratory services, and where he agrees to accept medicare assignment, the physician would be reimbursed at 100 percent of the fee schedule amount (or, if lower, the billed charge) with deductible and coinsurance waived. Physicians not accepting assignment would continue to be reimbursed at 80 percent of the fee schedule amount or (if lower, 80 percent of the billed charge) with the usual deductible and coinsurance applying.

b. Coverage of hepatitis B vaccine

Medicare would cover hepatitis B vaccine furnished to medicare patients in hospitals and renal dialysis facilities. The part B deductible and coinsurance would be waived.

c. Pacemaker reimbursement review and reform

The Secretary would be required to issue guidelines on the indications for, and frequency of, transtelephonic monitoring of pacemakers. If guidelines are not established by October 1, 1984, the proposal would establish a frequency schedule for certain types of pacemakers, with exceptions for medically documented cases.

The Secretary would be required to study reimbursement rates for physicians' services with res[illegible] to pacemakers, taking into consideration changes in surgical procedures that have taken place over the years.

The Food and Drug Administration (FDA) is to establish a registry of all implanted pacemakers.

d. Payment for debridement of mycotic toenails

Medicare would cover debridement of mycotic toenails no more frequently than every 60 days, unless medical necessity is documented.

e. Payment for costs of hospital-based mobile intensive care units

Certain services of mobile intensive care units could be covered under medicare part A under specified circumstances in States with Statewide prospective payment systems.

f. Payment for physicians' services furnished to hospital inpatients

The committee agreed to to the following committee amendment to the committee bill:

Prevailing charges for physicians' services provided to hospital inpatients would be frozen at the June 30, 1984 level, effective July 1, 1984 through June 30, 1985. There would be no provision for a catch-up in subsequent years.

Physicians would be required to accept medicare assignment for all services provided to medicare hospital inpatients until six months after the Congress receives the Secretary's report on including physician payments under the diagnostic related group (DRG) prospective payment system, which under the bill would be due by July 1, 1985.

To participate in medicare, each hospital would be required to obtain from each doctor on its medical staff an agreement to accept assignment for any medicare inpatient services rendered in the hospital.

2. Miscellaneous administrative changes

a. Presidential appointment of and pay level for the Administrator of the Health Care Financing Administration

The bill would provide for the Presidential appointment of the Administrator of the Health Care Financing Administration with the advice and consent of the Senate. The position and pay of the Administrator would be increased to Level IV of the Executive Schedule.

b. Permit limited representation on peer review organization (PRO's)

One person who is a governing body member, officer or managing employee of a health care facility would be permitted to be a member of the governing board of a PRO with less than 15 members; in the case of a PRO with more than 15, two such members would be permitted.

c. Access to home health services

The bill would permit a physician, who has a financial interest in a home health agency that is sole community provider, to carry out the certification and plan-of-care functions for patients who receive services from the agency, and to delete from the list of disqualified physicians uncompensated officers or directors of incorporated home health agencies.

d. Repeal of Special tuberculosis treatment requirements

The bill would repeal the special tuberculosis requirements under medicare and medicaid.

e. Indirect payment of supplementary medical insurance benefits

The bill would permit part B payments to be made to a health benefits plan where payment is accepted by the physician or other supplier as payment in full.

f. Including podiatrists and dentists in the definition of physician for certain purposes

A podiatrist (acting within the scope of his practice) would be considered a physician for purposes of coverage of outpatient physical therapy, which requires that the patient be "under the care of a physician." A podiatrist or dentist (acting within the scope of his practice) would be considered a physician for purposes of coverage of outpatient ambulatory surgery in a surgeon's office.

g. Establishment by physical therapist of plans for physical therapy

Either a physical therapist or a physician would be permitted to establish a plan of treatment for physical therapy services. The physician would still be required to review the plan periodically, as under existing law.

h. Access to records of subcontractors

The bill would increase from $10,000 to $50,000 the minimum value of the agreement between a medicare provider and a subcontractor for purposes of requiring access to subcontractor records.

i. Medicare recovery against certain third parties

The bill would establish the right of medicare to recover directly from certain third parties, such as workers compensation, auto and liability insurance.

j. Use of accrediting organizations for certain entities furnishing services

The bill would authorize the Secretary to rely on certain accrediting organizations in determining whether rural health clinics, laboratories, clinics, rehabilitation agencies, including outpatient rehabilitation facilities, psychiatric hospitals and public health agencies meet medicare requirements (and clarify the Secretary's authority with respect to ambulatory surgical centers).

k. Confidentiality of accreditation surveys

The bill would extend to surveys by the American Osteopathic Association and other national accreditation organizations the same disclosure protections given JCAH surveys.

l. Thirty-day coverage for services furnished by a home health agency after agreement has been terminated

The bill would change from the end of the calendar year to 30 days after termination of a home health agency agreement, the ending of coverage for services provided under a plan of care established prior to the termination date of the participation agreement.

m. Termination of agreements with entities where owners and certain individuals have been convicted of certain offenses

The bill would authorize the Secretary to exclude from medicare participation any entity in which ownership or controlling interest is held by a person convicted of a program-related criminal offense, or in which an officer, director, agent or managing employee was convicted of such a criminal offense.

n. Elimination of the Health Insurance Benefits Advisory Council

The bill repeals section 1867 of the Social Security Act, thus eliminating the Health Insurance Benefits Advisory Council.

o. Open enrollment for health maintenance organizations and competitive medical plans

The Secretary would be directed to designate one 30-day period each year in which all of the medicare participating HMO's in a geographic area must have an open enrollment period.

p. Date for report on physician's payments

The bill would specify the date on which the Secretary of Health and Human Services is required by present law to report to Congress recommendations on the advisability and feasibility of making payments for physician's services furnished to hospital inpatients based on a DRG system and legislative recommendations thereon. The report would be due July 1, 1985.

q. Flexible sanctions for noncompliance with requirements for end-stage renal dialysis facilities

The bill would allow the Secretary to apply intermediate sanctions to ESRD facilities when noncompliance does not justify decertification of such facilities.

r. Removing costs of nurse anesthetists from DRG-based payments

For a temporary period, hospitals employing certified registered nurse anesthetists (CRNAs) would be reimbursed on a reasonable cost basis, as determined by the Secretary, for services of CRNAs. The Secretary would be required to report with recommendations on payments to CRNAs under the prospective payment system.

s. Determination of hospital area wage index

The Secretary would be directed to establish criteria under which a hospital could demonstrate, for purposes of medicare prospective payment, that the area wage index inaccurately reflects the labor market conditions it actually faces; adjustments in payment could be made where the Secretary deems appropriate. The Secretary would also be directed to consult with the Department of Labor and BLS to develop an improved area wage index.

t. Definition of bona fide emergency services

Existing law provides for reduced payment for physicians' services in hospital outpatient departments except for "bona fide emergency services." The bill would establish the following statutory definition of emergency services.

Services provided in hospital emergency rooms after the onset of a medical condition manifesting itself by symptoms of sufficient severity that the absence of immediate medical attention could reasonably be expected by a prudent layperson possessing an average knowledge of health and medicine to result in (a) placing the patient's health in jeopardy; (b) serious impairment to bodily functions; (c) serious dysfunction of any bodily organ or part; or (d) development or continuance of severe pain.

u. Delay of effective date for single-rate for skilled nursing facilities

The single-rate for hospital-based freestanding skilled nursing facilities would be delayed from October 1, 1983, until April 1, 1984.

Title XI.—Trade Adjustment Assistance Programs

Title XI contains three amendments to the trade adjustment assistance (TAA) programs for workers and firms under the Trade Act of 1974, as amended under the Omnibus Budget Reconciliation Act of 1981. These programs were reauthorized for a two-year period until September 30, 1985, under Public Law 98-120. The amendments become effective on the date of enactment of the bill.

Title XII.—Highway Use and Diesel Fuel Tax Provisions

1. Heavy vehicle use tax

Under present law, the highway use tax is scheduled to increase beginning July 1, 1984, reaching a maximum rate of $1,900 per year on the heaviest vehicles by July 1, 1988. The bill restructures the use tax to eliminate tax on vehicles under 55,000 pounds and provide a maximum tax rate of $500 per year, effective July 1, 1984. Rules applicable to small owner-operators are amended effective July 1, 1984. The Department of Transportation is instructed to study improvements in the application of the use tax to vehicles over 80,000 pounds.

2. Diesel fuel tax

The bill increases the excise tax on diesel fuel sold for use in highway vehicles by 5.5 cents per gallon to 14.5 cents per gallon. In addition, owners of recent model year diesel vehicles (having a gross vehicle weight under 10,000 pounds) and purchasers of new diesel vehicles (having a gross vehicle weight under 10,000 pounds) receive a one-time advance repayment reflecting the amount of extra diesel fuel taxes expected to be paid over the normal useful life of the vehicle. This provision is effective on July 1, 1984, for vehicles purchased before January 1, 1988.

III. GENERAL REASONS FOR THE BILL

Despite the recovery of the U.S. economy in 1983, there is now widespread concern that the massive budget deficits projected by both the Office of Management and Budget and the Congressional Budget Office will threaten continued economic growth and investment. The first objective of the bill is to reduce these budget deficits in order to safeguard the economic recovery. The second objective of the bill is to prevent further erosion of the tax base as a result of tax sheltering activity. The budget deficit has been aggravated by the growth of tax shelter partnerships and the creative use of structural tax rules to achieve tax benefits far in excess of those intended by Congress. The third objective of the bill is to ensure that all taxpayers pay a fair share of the tax burden. The fourth principal objective of the bill is to improve the administration and efficiency of the tax system and certain spending programs.

Deficit Reduction

In February 1984, the Congressional Budget Office estimated that current fiscal policy would produce a substantial growth in the Federal deficit from $195 billion in fiscal year 1983 to $326 billion in 1989. Furthermore, an increasing portion of the budget deficit is attributable to structural features of tax and spending programs rather than adverse cyclical conditions. The Congressional Budget Office estimates that the structural budget deficit will more than double relative to national product, from 2.4 percent in 1983 to 5.5 percent of gross national income in 1989. This rising stream of deficits is projected to add more than $1.5 trillion to the national debt over the 1984–89 period, increasing Federal borrowing from one-third to one-half of gross national product. The cost of servicing the debt is projected to increase from 11 percent to 16 percent of Federal budget outlays from 1983 to 1989, which will make it even more difficult to cut the deficit in future budget cycles if nothing is done this year.

Unless some some action is taken to reduce these budget deficits, there is widespread concern that it may be difficult to sustain real economic growth and price stability. If monetary policy continues to be anti-inflationary, the competition between public and private borrowing as the economy approaches full employment will put upward pressure on interest rates. High real interest rates harm private capital formation and contribute to the appreciation of the dollar, relative to foreign currencies, which adversely affects the merchandise trade balance. The ill effects of mounting budget deficits and high real interest rates are already apparent in the deteriorating trade balance, which recorded a deficit in 1983 exceeding $60 billion.

In recognition of the deficit problem, the President has called for a $100 billion "downpayment" on the budget deficit over the next three years. The bill includes revenue measures which raise $2.0 billion in fiscal 1984, $9.2 billion in 1985, $16.7 billion in 1986, and $21.3 billion in 1987, for a total revenue increase of $49.2 billion over the four-year period. Thus, the bill achieves half of the deficit reduction target through revenue increases.

The bill contains numerous provisions which are designed to reduce the budget deficit in a fair and equitable manner. The principal deficit-reducing measure in the bill is a tax freeze which postpones eleven tax reductions scheduled to take effect in this and subsequent years. This tax freeze, which does not raise any taxes above their level at the end of 1983, is the least painful way to reduce the deficit, and causes far less disruption than the imposition of new tax increases.

Insofar as possible, the committee has attempted to meet its deficit reduction target without harming the average taxpayer or average program beneficiary. When provisions do affect the average taxpayer, this has been because the committee believed that present law provided unnecessary benefits. For example, the bill modifies the income averaging formula because use of this provision has expanded dramatically in recent years and need not be as generous in view of the tax rate cuts enacted in 1981. On the outlay side, the committee has acted to reduce the costs of the Medicare program while protecting its integrity for present and future beneficiaries.

Prevention of Tax Base Erosion

The committee believes that the proliferation of tax shelters has seriously eroded the tax base and has adversely affected the efficiency and equity of the tax system. The increase in tax shelter activity has aggravated the nation's deficit problem, particularly in the case of "abusive" shelters where the tax write-offs are several times larger than the equity investment. The proliferation of tax sheltered investments shifts the tax burden to those taxpayers who do not or cannot participate in such investments, and the organization and promotion of tax shelters diverts thousands of skilled professionals from more productive activities. Accordingly, the committee bill contains a number of provisions designed to eliminate unintended tax results achieved in certain partnership transactions.

Many tax shelter transactions derive unintended tax benefits by exploiting the Code's failure to take into account the time value of money. For example, the tax law has been slow to require economic accrual of interest on obligations issued at a discount. The bill requires the economic accrual of interest on deferred payments made in connection with the sale or exchange of property and services in certain transactions that are excluded under current law. This will limit the extent to which taxpayers can achieve substantial reductions in tax liability merely by changing the form in which property is sold. A second example of how the tax base is being eroded by inadequate accounting for the time value of money is the current deduction that some employers claim for future employee benefit costs. The bill generally would limit such deductions to the amount paid in the current year whether through a funded or unfunded arrangement.

Another area where the tax base has been seriously eroded is the use of tax/exempt bonds for private purposes. In recent years, the growth of such bonds has proceeded far beyond what was originally intended by Congress and has significantly raised interest rates on the general obligation bonds that State and local governments issue to finance their operations. The committee bill places certain limits on the use of private purpose tax-exempt bonds in order to curb the uncontrolled Federal tax expenditure for private property financed with these bonds.

The committee is also concerned about the use of leasing and sale-leaseback arrangements by Federal agencies, State and local governments, and other tax-exempt entities in order to obtain the advantage of accelerated depreciation and other tax benefits. In these lease transactions, a portion of the tax benefit available to the lessor is passed through to the nontaxable lessee in the form of lower rents. Thus, the leasing arrangement allows certain tax benefits to flow through to nontaxable entities which are not eligible for them on their own account. The difference between the cost of leasing and purchasing property is a benefit which is effectively paid by the Federal government to the tax-exempt entity. Moreover, the cost to the Federal government is more than the benefit received by the tax-exempt entity—some of the benefits go to the owner of property and to financial and other intermediaries. The committee bill eliminates the excessive tax benefits for property used by tax-exempt entities.

Tax Equity

The committee is concerned that the tax system be as equitable as possible and, equally important, perceived by taxpayers as fair. Compliance with the tax law is likely to decline if taxpayers believe that the burden is unfairly distributed as a result of inequities in the tax system. One area where there appears to be increased inequity is the ability of employers to compensate their employees tax-free by using the goods and services they sell to the general public instead of cash. The widespread use of such fringe benefits not only threatens to shrink the base of the income and payroll taxes, but also shifts a disproportionate share of the tax burden to those individuals whose compensation is paid entirely in cash. The committee believes that it is unfair to provide tax-free treatment for such noncash compensation that is furnished only to corporate officers and highly paid executives. Under the bill, these fringe benefits would be available tax-free to highly compensated employees only if the benefits are provided on substantially equal terms to other employees.

A similar inequity arises where employers provide employee benefits through the establishment of a tax-exempt employees' beneficiary association (VEBA). Some VEBAs are currently being used to allow employees to earn tax-exempt interest on excessive reserves. The bill would limit the extent to which investment income in such funds could be earned tax-free, and thus provide for more uniform taxation of employers.

The committee believes that the structure of the taxation of life insurance companies should be fundamentally revised to ensure similar tax treatment of different segments of the industry. The Life Insurance Company Tax Act of 1959 (on which present law is based) was designed to ensure that the life insurance industry as a whole paid a target amount of tax and that the distribution of this tax burden within the industry was balanced. The three-phase structure of present law is extremely complex, and in the past few years the presence of high interest rates and new investment-oriented life insurance products has substantially redistributed the industry's tax burden. The committee believes that a simpler single-phase tax, more like that imposed on corporations in other industries, will ensure that life insurance companies face comparable tax burdens.

The committee has also recommended changes in the heavy vehicle use tax provisions of the Surface Transportation Act of 1982. These changes are designed to more equitably distribute the burden of such taxes among users of the nation's highway system while maintaining adherence to cost allocation principles adopted in earlier legislation.

Improved Administration and Simplification

The committee has examined numerous provisions of the tax law, as well as the the social security disability program and the Medicare program, and has recommended simplification or administrative improvements in several areas. On the spending side, the bill provides for needed reforms in the administration of the disability determination process. The current review process has in some cases resulted in an unwarranted termination of benefits. The bill establishes a standard of medical improvement for evaluation of continuing eligibility as well as a standard regarding multiple impairments. It provides for a temporary delay of mental impairment reviews until new criteria are established. The bill requires uniform public policy for all levels of adjudication, continuation of benefit payments while cases are under appeal, compliance with circuit court decisions, and certain other changes.

In the area of medicare, the committee has made substantial spending reductions over the next three years. In addition, it has adopted several amendments to improve the adequacy of the program and to increase its administrative efficiency. In making these reductions in spending, the committee has made every effort to assure that there will be no harmful reductions in coverage to beneficiaries nor any increased costs to the elderly.

On the tax side, the committee has recommended changes in reporting requirements and penalties in order to improve compliance with the tax system. The committee believes that unless continued efforts are made to reverse the rising trend of noncompliance, the integrity of the tax system will be severely eroded. The provisions in this bill complement and strengthen the compliance measures enacted in the Tax Equity and Fiscal Responsibility Act of 1982. The committee also believes that efforts to simplify the tax code are also likely to improve compliance. The bill contains a number of provisions, such as the simplification of income tax credits, which are primarily designed to make the tax rules easier to understand and use.

IV. REVENUE AND OUTLAY EFFECTS OF THE BILL

Revenue effects

The revenue provisions of the committee bill involving statutory changes are estimated to increase net budget receipts by $2.0 billion in fiscal year 1984, $9.2 billion in fiscal year 1985, $16.7 billion in fiscal year 1986 and $21.3 billion in fiscal year 1987. Thus, the total revenue raised during the fiscal years 1984 through 1987, equals $49.2 billion.

Table IV-1 is a summary of the estimated revenue effects of the tax provisions of the committee bill for fiscal years 1984-1989 for the major tax categories of the bill (Titles I-VIII and XII).

Table IV-2 shows the estimated revenue effects of each specific tax provision of the committee bill (Titles I-VIII and XII) for fiscal years 1984-1989.

Outlay effects

The outlay provisions of the committee bill are estimated to have no budget impact in fiscal year 1984 and to decrease outlays by $269 million, $438 million, $608 million, and $— million for fiscal years 1984-1987, respectively. The total outlay savings for fiscal years 1984-1987 is $1,315 million. The impact of each provision is shown in greater detail in Part VI of this explanation.

Table IV-1

Summary of Estimated Revenue Effects of Tax Provisions of Committee Amendment to H.R. 4170, as Adopted by the Committee on Ways and Means, Fiscal Years 1984–89

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Title I. Tax Freeze; Tax Reform Generally	2,372	8,962	17,351	22,061	22,427	22,969
Title II. Life Insurance and IRA Provisions [1]	−267	−547	−694	−891	−1,077	−1,284
Title III. Private Foundation Provisions	−13	−45	−46	−47	−50	−53
Title IV. Simplification Provisions	149	1,038	309	437	469	476
Title V. Fringe Benefits Provisions	(2)	(2)	(2)	(2)	(2)	(2)
Title VI. Technical Corrections	(3)	(4)	(4)	(4)	(4)	(4)
Title VII. Private Purpose Bond Provisions	−31	−106	−157	−216	−372	−477
Title VIII. Miscellaneous Revenue Provisions	−55	−81	−49	−48	−24	−15
Title XII. Highway Use and Diesel Fuel Tax Provisions	−154	−46	19	−30	114	45
Total, Tax Provisions	**2,001**	**9,175**	**16,733**	**21,266**	**21,487**	**21,661**

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[1] The figures represent the estimated effects of the life insurance provisions assuming that certain temporary provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which provide for the taxation of insurance companies, are terminated. If these provisions were not allowed to expire at the end of 1983, the estimates would show increases in fiscal year receipts of $763 million in 1984, $884 million in 1985, $923 million in 1986, $997 million in 1987 and $1,076 million in 1988.

[2] Loss of less than $5 million.

[3] Loss of less than $10 million.

[4] Negligible.

Table IV-2

Estimated Revenue Effects of Tax Provisions of Committee Amendment to H.R. 4170, as Adopted by the Committee on Ways and Means, Fiscal Years 1984–89

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Title I. Tax Freeze; Tax Reforms Generally:						
A. Deferral of certain tax reductions:						
ITC for used property		44	104	112	65	
Finance leasing	63	351	875	1,404	1,445	739
Expensing of personal property	230	399	433	386	−118	−427
Employee stock ownership plans		304	626	749	365	64
Limits on pension plans			17	64	106	115
Net interest exclusion		1,024	2,858	3,100	3,366	3,637
Foreign earned income exclusion	4	31	80	106	107	79
Top estate and gift tax rate	(6)	129	399	503	578	439
Windfall profit tax on newly discovered oil	15	15				
Cigarette and liquor excise taxes [12]		125	1,773	1,914	835	19
Telephone excise tax [13]			1,168	2,016	803	
Subtotal	312	2,422	8,333	10,354	7,552	4,665
B. Tax-exempt entity leasing	683	990	1,740	3,070	4,877	6,978
C. Treatment of bonds and other debt instruments:						
Debt obligations acquired at a discount:						
Market discount	(10)	(10)	(10)	(10)	(10)	(10)
Original issue discount on tax-exempt	3	5	7	8	10	13

Table IV-2—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Certain short-term obligations issued at a discount	72	146	150	153	155	158
Income from factoring trade receivables		313	547	590	637	689
Deferred payment transactions:						
Time for inclusion or deduction of deferred interest and measurement of interest in deferred payment transactions	114	431	868	1,335	1,802	2,287
Subtotal, bonds and other debt instruments	189	895	1,572	2,086	2,604	3,147
D. Taxation of Corporations and Their Shareholders:						
Dividends received by corporations:						
Debt-financed portfolio stock	(4)	(4)	(4)	(4)	(4)	(4)
Extraordinary dividends received by corporations		140	100	100	100	100
Certain dividends received from RICs	(10)	(10)	(10)	(10)	(10)	(10)
Dividends received deduction compliance		(6)	(6)	(6)	(6).	(6)
Ordinary nonliquidating distributions of appreciated property (including royalty trusts)	3	18	64	114	169	227
Investment companies that accumulate earnings		62	78	33	35	36
RICs capital gains distributions			83	89	96	103

Expenses incurred in connection with short sales	22	32	38	43	48	54
Transfers of partnership interests by corporations		(3)	50	50	50	50
Transactions in stock warrants	(6)	(6)	(6)	(6)	(6)	(6)
Exchange of debt for stock	(6)	(6)	(6)	(6)	(6)	(6)
Distribution of debt by a corporation—earnings and profits	(4)	(4)	(4)	(4)	(4)	(4)
Definition of affiliated group of corporations		11	29	48	27	8
Collapsible corporations	5	57	196	305	351	382
NOL carryover date	(9)	(9)	(9)	(9)	(9)	(9)
Subtotal, corporate provisions	30	320	638	782	876	960
E. Partnership and related provisions:						
Use of allocations to affect income or loss:						
Allocations with respect to contributed property	4	61	147	178	240	298
Allocations of partnership losses		50	75	100	100	100
Use of partnerships to convert character of income or to defer income:						
Character of gain or loss on contributed property		24	63	66	67	69
Organizational fees and other capital expenditures		20	51	60	69	78
Disguised sales	(6)	(6)	(6)	(6)	(6)	(6)
Tiered partnerships	(3)	(3)	(3)	(3)	(3)	(3)
Like-kind exchanges of partnership interests		226	630	667	788	842
Deferred like-kind exchanges		(10)	(10)	(10)	(10)	(10)

Table IV-2—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Subtotal, partnership, etc. provisions	4	381	966	1,071	1,264	1,387
F. Trust provisions:						
Multiple trusts	(6)	(6)	(6)	(6)	(6)	(6)
Trusts distributions	(6)	64	261	409	438	467
Subtotal, trusts	(6)	64	261	409	438	467
G. Accounting changes:						
Premature accruals	303	643	646	603	576	563
Prepaid expenses	123	277	88	106	127	152
LIFO conformity		105	185	200	200	200
Subtotal, accounting changes	426	1,025	919	909	903	915
H. Straddles provisions	406	163	82	60	48	39
I. Employee benefit items	23	146	178	224	274	335
J. Foreign tax provisions:						
Transactions involving foreign corporations:						
Certain transfers of appreciated property			12	127	324	540
Decontrol of foreign corporations	(3)	(3)	(3)	(3)	(3)	(3)
Recharacterization of U.S. income as foreign income	24	69	93	102	113	124

Recharacterization of interest income as dividend income	(4)	(4)	(4)	(4)	(4)	(4)
Use of territories to avoid U.S. tax on foreign investors	(4)	(4)	(4)	(4)	(4)	(4)
Source of shipping income	14	39	51	55	58	63
Foreign collapsible corporations	(6)	(6)	(6)	(6)	(6)	(6)
Subtotal, foreign corporations	38	108	156	284	495	727
K. Compliance provisions		20	92	175	232	255
L. Miscellaneous provisions:						
Avoidance of rules relating to transfers of depreciable property between related taxpayers	(6)	(6)	(6)	(6)	(6)	(6)
Payments of excise tax revenues to Puerto Rico and the U.S. Virgin Islands	(11)	(11)	(11)	(11)	(11)	(11)
Luxury cars ($21,000 base)	20	79	130	160	180	194
Inclusion of tax benefit items in income		229	255	274	300	330
Below market-interest and interest-free loans	108	126	143	150	158	166
Income averaging	133	1,994	1,886	2,053	2,226	2,404
Subtotal, misc. provisions	261	2,428	2,414	2,637	2,864	3,094
Total, tax freeze, tax reform generally	**2,372**	**8,962**	**17,351**	**22,061**	**22,427**	**22,969**
Title II. Life Insurance and IRA Provisions:						
Life insurance tax provisions(1)	−252	−481	−553	−664	−756	−861
Nondeductible IRAs ($1,750)	−15	−66	−141	−227	−321	−423
Total, life insurance and IRA provisions	**−267**	**−547**	**−694**	**−891**	**−1,077**	**−1,284**
Title III. Private Foundations Provisions	−13	−45	−46	−47	−50	−53

Table IV-2—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Title IV. Simplification Provisions:						
A. Estimated tax provisions:						
Measure penalties from "exception" amounts			−63	−69	−76	−84
Repeal "90 percent" and "this year's tax rates" exception from penalty		135	12	11	9	7
Allow penalty waiver	(2)	(2)	(2)	(2)	(2)	(2)
Estimated payments of the alternative minimum tax required		611	45	49	52	56
B. Domestic relations:						
Treatment of transfer of property between spouses or incident to divorce		(2)	(2)	(2)	(2)	(2)
Tax treatment of alimony separate maintainence payments		−8	−49	−12	25	41
Dependency exemption in the case of child of divorced parents		(3)	(3)	(3)	(3)	(3)
Innocent spouse		(3)	(3)	(3)	(3)	(3)
Estate tax treatment of certain property settlements		(3)	(3)	(3)	(3)	(3)
Dependency exemption allowed for individuals in sheltered workshops		(3)	(3)	(3)	(3)	(3)
C. At-risk rules		(3)	(3)	(3)	(3)	(3)
D. Estate tax provisions:						
Permanent rules for reforming governing instruments creating charitable remainder trusts and other charitable interests	(2)	(2)	(2)	(2)	(2)	(2)

Alternative valuation election available only where it results in reduction of gross estate and estate tax		10	10	10	10	10
E. Foreign provisions:						
Definition of resident and nonresident aliens		(4)	(4)	(4)	(4)	(4)
Treatment of community income		(6)	(6)	(6)	(6)	(6)
Amendments relating to foreign personal holding companies	(3)	(3)	(3)	(3)	(3)	(3)
Amendments relating to section 1248	(3)	(3)	(3)	(3)	(3)	(3)
Coordination of subpart F with foreign personal holding company provisions	(6)	(6)	(6)	(6)	(6)	(3)
Stapled stock	(6)	(6)	(6)	(6)	(6)	(3)
F. Miscellaneous Treasury administrative provisions:						
Simplification of certain reporting requirements						
Removal of $1,000,000 limitation on working capital fund						
Increase in limitation on revolving fund for redemption of real property	(3)	(3)	(3)	(3)	(3)	(2)
Removal of $1,000,000 limitation on authority to dispose of obligations	(3)	(3)	(3)	(3)	(3)	(3)
Secretary of the Treasury authorized to accept gifts and bequests	(3)	(3)	(3)	(3)	(3)	(3)
Extension of time for court review of jeopardy assessment where prompt service not made on U.S	(3)	(3)	(3)	(3)	(3)	(3)
Extension of period to assess unpaid taxes	(6)	(6)	(6)	(6)	(6)	(6)
Lien on assets of financial institutions for unpaid drafts	(3)	(3)	(3)	(3)	(3)	(3)

Table IV-2—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Disclosure of windfall profit tax to state tax agencies						
Provisions relating to distilled spirits:						
Repeal of occupational tax on manufacturers of stills and containers	(5)	(5)	(5)	(5)	(5)	(5)
Allowance of drawback claims even where certain requirements not met	(5)	(5)	(5)	(5)	(5)	(5)
Disclosure of alcohol fuel producers to administrators of State alcohol laws						
Repeal of stamp requirement for distilled spirits	(7)	(7)	(7)	(7)	(7)	(7)
G. Tax Court provisions:						
Small tax cases						
Annuities to survivors of Tax Court judges	(8)	(8)	(8)	(8)	(8)	(8)
Proceedings which may be assigned to commissioners						
Special trial judges						
Publicity of Tax Court proceedings						
Retirement age for Tax Court judges						
H. Simplification of income tax credits	100	183	179	194	110	25
I. Miscellaneous tax provisions:						
Rollover of certain partial distributions from qualified plans	(3)	(3)	(3)	(3)	(3)	(3)
Treatment of certain related party transactions	50	114	185	264	350	433

Preferred stock eligible for small business corporation treatment	(2)	(2)	(2)	(2)	(2)	(2)
Medical expense deduction for certain lodging	−1	−7	−10	−10	−11	−12
Study of simplified gross income tax						
J. Repeal of certain obsolete provisions:						
Termination of rules relating to qualified bond purchase plans and retirement bonds						
Repeal of section 1251 (relating to gains from disposition of certain property used in farming)						
Total, simplification provisions	**149**	**1,038**	**309**	**437**	**469**	**476**
Title V. Fringe Benefits Provisions	(2)	(2)	(2)	(2)	(2)	(2)
Title VI. Technical Corrections	(9)	(3)	(3)	(3)	(3)	(3)
Title VII. Tax-exempt Bond Provisions:						
Mortgage bond extension and certificates	−61	−248	−521	−815	−1,103	−1,301
IDBs	55	262	659	1,103	1,391	1,573
Certain educational tax-exempt bonds organizations	(9)	(9)	(9)	(9)	(9)	(9)
Private purpose IDBs	−1	−3	−9	−15	−18	−22
Other tax-exempt bonds provisions	−24	−117	−286	−489	−642	−727
Total, tax-exempt bond provisions	**−31**	**−106**	**−157**	**−216**	**−372**	**−477**
Title VIII. Miscellaneous Revenue Provisions:						
Tax treatment of certain conversions of residential rental property into condominium units	−33	−72	−71	−53	−29	−18

Table IV-2—Continued

[Millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Nonrecognition of gains from any net gift made before March 4, 1981	(2)	(2)	(2)	(2)	(2)	(2)
Disaster loss deduction—mudslides, etc	−15	−12	−12	−13	−13	−14
Money purchase pension plans	(3)	(3)	(3)	(3)	(3)	(3)
Payment-in-kind (PIK)	−7	−8	15			
1978 unemployment benefits	(5)					
Travelling expenses at Nekoma ABM site	(5)					
Private relief for winner of contest award	(3)					
Tips reporting for FUTA		16	26	28	30	32
Airline pilots retirement	(3)	(3)	(3)	(3)	(3)	(3)
Estate tax installment sales		−5	−7	−10	−12	−15
Regulated investment co. provision	(3)	(3)	(3)	(3)	(3)	(3)
Cooking wine	(3)	(3)	(3)	(3)	(3)	(3)
501(c)(3) status for dependent care organization		(2)	(2)	(2)	(2)	(2)
Sub S amendment	(5)	(5)	(5)	(5)	(5)	(5)
Total, miscellaneous provisions	−55	−81	−49	−48	−24	−15
Title XII. Highway Use and Diesel Fuel Tax Provisions:						
Heavy vehicle use tax	−240	−548	−616	−675	−581	0
Diesel fuel tax increase	86	502	635	645	695	45
Total, highway use/diesel fuel taxes	−154	−46	19	−30	114	45
Grand Total, Tax Provisions						

Footnotes to Table IV-2:

[1] The figures represent the estimated effects of the life insurance provisions assuming that certain temporary provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which provide for the taxation of insurance companies, are terminated. If these provisions were not allowed to expire at the end of 1983, the estimates would show increases in fiscal year receipts of $763 million in 1984, $884 million in 1985, $923 million in 1986, $997 million in 1987 and $1,076 million in 1988.

[2] Loss of less than $5 million.

[3] Negligible.

[4] Gain of less than $10 million.

[5] Loss of less than $1 million.

[6] Gain of less than $5 million.

[7] Reduces outlays by $2 million.

[8] Increase outlays by a negligible amount.

[9] Loss of less than $10 million.

[10] The effects of this provision are included in the estimated revenues for other provisions.

[11] This provision decreases fiscal year outlays by $149 million in 1985, $240 million in 1986, $260 million in 1987, and $264 million in 1988 and 1989.

[12] The figures represent net increases, after accounting for lower income tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $167 million in fiscal year 1985, $2,364 million in 1986, and $2,553 million in 1987.

[13] The figures represent net increases, after accounting for lower income tax receipts. Increases in general fund receipts from this tax before taking account of the income tax offset are estimated at $1,559 million in 1986 and $2,689 million in 1978.

V. EXPLANATION OF PROVISIONS

TITLE I—TAX FREEZE; TAX REFORMS GENERALLY

A. Deferral of Certain Tax Reductions

1. Postpone Increase in Amount of Used Property Eligible for Investment Tax Credit (sec. 12 of the bill and sec. 48(c)(2) of the Code)

Present Law

The maximum amount of a taxpayer's investment in used property that is eligible for the regular investment tax credit in a taxable year is $125,000. In the case of a married individual who files a separate return, the limit is $62,500. These limits are scheduled to increase to $150,000 and $75,000, respectively, for taxable years beginning after 1984.

Reasons for Change

The committee believes that delaying a relatively small increase in the amount of used property eligible for the investment credit can have no important effect on overall investment in the economy, but will make a certain contribution in reducing budget deficits.

Explanation of Provision

The bill holds the maximum amount of used property eligible for the investment credit at its current level of $125,000 per year until taxable years beginning after 1987, when this limit is increased to $150,000.

Effective Date

The provision is effective with respect to taxable years ending after 1983.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $44 million in 1985, $104 million in 1986, $112 million in 1987, and $65 million in 1988.

2. Postpone Finance Lease Provisions (sec. 13 of the bill and secs. 168(f)(8) and 168(i) of the Code)

Present Law

Overview

Prior to the enactment of the Economic Recovery Tax Act of 1981 (ERTA), the law contained rules (pre-safe harbor lease rules) to determine who owns an item of property for tax purposes when the property is subject to an agreement which the parties characterize as a lease. Such rules are important because the owner of the property is the person entitled to claim cost recovery deductions and investment tax credits with respect to the property. The pre-safe harbor lease rules attempted to distinguish between true leases, in which the lessor owned the property for tax purposes, and conditional sales or financing arrangements, in which the user of the property owned the property for tax purposes. These rules generally were not written in the Internal Revenue Code. Instead they evolved over the years through a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service. Essentially, the law was that the economic substance of a transaction, not its form, determined who was the owner of property for tax purposes. Thus, if a transaction was, in substance, simply a financing arrangement, it would be treated that way for tax purposes, regardless of how the parties chose to characterize it. Lease transactions could not be used solely for the purpose of transferring tax benefits. They had to have nontax economic substance. The pre-safe harbor lease rules are discussed below.

ERTA provided a new set of rules which represented a major departure from the prior law. These provisions were intended to be a means of transferring tax benefits rather than a means of determining which person is in substance the owner of the property. Under these rules (safe-harbor lease rules), certain transactions involving tangible personal property were treated as leases for Federal income tax purposes regardless of their nontax economic substance. If a transaction met the safe harbor requirements, the lessor in the agreement was treated as the owner for Federal income tax purposes, entitled to cost recovery deductions and investment credits. Under these rules, by entering into a nominal sale and safe-harbor leaseback, a person who acquired and used the property could have, in effect, sold tax benefits associated with the property, while retaining all other economic benefits and burdens of ownership. The pre-safe harbor leasing rules continued to apply for transactions not qualifying under the safe-harbor lease rules or when safe harbor was not elected.

The Tax Equity and Fiscal Responsibility Act of 1983 (TEFRA) generally repealed safe-harbor leasing. In its place, TEFRA substituted a modified form of safe-harbor leasing called finance leasing. Under the finance leasing provisions, taxpayers are still to some extent able to sell tax benefits with respect to property while retaining economic benefits and burdens of ownership. The pre-safe harbor lease rules continue to apply for transactions as to which the finance lease rules are unavailable or not elected.

Pre-safe harbor leasing rules

Underlying principles

In general, the determination of lease treatment under the pre-safe harbor leasing rules required a case-by-case analysis based on all facts and circumstances. Although the determination of whether a transaction was a lease was inherently factual, a series of general principles was embodied in court cases, revenue rulings, and revenue procedures. Those principles are still used in determining the character of transactions not eligible for the safe-harbor or finance lease rules and for which the safe-harbor or finance lease election is not made.

For a transaction to be a lease under those rules, the lessee could not hold title to or have an equity interest in the property. However, the fact that the lessor had title did not guarantee that the lessor was the owner for Federal income tax purposes. Both the courts and the IRS looked to additional criteria in determining whether a transaction was a lease. These criteria focused on the substance of the transaction rather than its form. The courts did not disregard the form of a transaction simply because tax considerations were a significant motive so long as the transaction also had a bona fide business purpose and the lessor retained sufficient burdens and benefits of ownership.[1]

To be entitled to depreciation deductions as the owner of the property, the lessor had to show that the property was being used for a business or other income-producing purpose. To have had a business purpose, the person claiming ownership (i.e., the lessor) at least had to have a reasonable expectation that he would derive a profit from the transaction independent of tax benefits.[2] This requirement precluded lease treatment for a transaction intended merely to reduce the user's costs by utilizing the lessor's tax base. For a sale-leaseback, other nontax business motives were considered in determining the substance of the transaction.

The fact that the lessor in a lease financing transaction could show a profit or business purpose, however, did not automatically result in lease treatment under pre-safe-harbor lease rules, since a profit or business motive could also exist in a financing arrangement. In addition, the lessor had to retain meaningful benefits and burdens of ownership.[3] Thus, lease treatment was denied under pre-safe-harbor lease rules if the user had the option to acquire the property at the end of the lease for a price that either was nominal in relation to the value of the property at the time when the option could be exercised (as determined at the time the parties entered into the agreement) or which was relatively small when compared with the total payments required to be made.[4]

Where the residual value of the property to the lessor was nominal, the lessor was viewed as having transferred full ownership of the property for the rental fee. Where the purchase option was more than nominal but relatively small in comparison with fair market value, the lessor was viewed as having transferred full ownership because of the likelihood that the lessee would exercise the bargain purchase option.[5] Furthermore, if the lessor could force the lessee to purchase the property at the end of the lease (a put), the transaction might also be denied lease treatment under pre-safe harbor lease rules because the put eliminated the risk borne by owners of property that there would be no market for the property at the end of the lease.

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[1] *See, Hilton* v. *Commissioner*, 74 T.C. 305 (1980), *aff'd* 671 F.2d 316 (9th Cir. 1982); *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), *rev'g.* 536 F.2d 746 (8th Cir. 1976); and Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein); *See generally, Gregory* v. *Helvering*, 293 U.S. 465 (1935).

[2] *See, Hilton* v. *Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982).

[3] *See, Frank Lyon Co.* v. *United States*, 435 (U.S. 561 (1978), *rev'g.* 536 F.2d 746 (8th Cir. 1976); and Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

[4] *See*, Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

Objective guidelines used in structuring transactions

The question of exactly what burdens and benefits of ownership had to be retained by the lessor under pre-safe harbor lease rules created some confusion and difficulty for people trying to structure leases that, at least in part, were motivated by tax considerations. To give taxpayers guidance in structuring leveraged leases (i.e., where the property is financed by a nonrecourse loan from a third party), the Internal Revenue Service in 1975 issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines were met and if the facts and circumstances did not indicate a contrary result, the Service issued (and continues to issue) an advance letter ruling under the pre-safe harbor lease rules that the transaction was a lease and that the lessor was the owner for Federal income tax purposes.

The guidelines applied only to leveraged leases of equipment. The general principles described above continued to govern nonleveraged leases and leases of real property. The guidelines were not by their terms a definitive statement of legal principles and were not intended for audit purposes. If less than all requirements of the guidelines were met, a transaction might still be considered a lease if, after considering all facts and circumstances, the transaction was a lease under the general principles discussed previously. However, in practice, many taxpayers took into account the guidelines' requirements in structuring transactions. The guidelines may be viewed as a type of safe-harbor.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. *Minimum investment.*—The lessor must have a minimum 20 percent unconditional at-risk investment in the property. This rule represents an attempt to ensure that the lessor suffers some significant loss if the property declines in value.

2. *Purchase options.*—In general, the lessee may not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). This rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the option date. In addition, when the property is first placed in service by the lessee, the lessor cannot have a contractural right to require the

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[5] *See, M&W Gear Co.* v. *Commissioner*, 446 F.2d 841 (7th Cir. 1971).

lessee or any other party to purchase the property, even at fair market value.

The fair market value purchase option requirement fulfills three purposes related to the determination of the economic substance of the transaction. First, it ensures that the lessor bears the risk implicit in ownership that no market will exist at the end of the lease. The owner of depreciable property is the person who bears any decline in value of the asset. Second, it ensures that the lessor has retained an equity interest in the property. Any fixed price option represents a limitation on the lessor's right of full enjoyment of the property's value. Third, it limits the ability of the parties to establish an artificial rent structure to avoid the cash flow test (described below). However, several courts have held that the mere existence of a fixed price purchase option does not prevent lease treatment so long as the lessor retains other significant burdens and benefits of ownership.[6]

3. *Lessee investment precluded.*—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property. The rationale is that a lessee investment may suggest that the lessee is in substance a co-owner of the property.

4. *No lessee loans or guarantees.*—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any lessor loan.

5. *Profit and cash flow requirements.*—The lessor must expect to receive a profit from the transaction and have a positive cash flow from the transaction independent of tax benefits. As mentioned previously, a profitability requirement is based on the requirement that lease transactions must have a business purpose independent of tax benefits.

6. *Limited use property.*—Under Revenue Procedure 76-30, 1976-2 C.B. 647, property that can be used only by the lessee (limited use property) is not eligible for lease treatment. The rationale is that if the lessee is the only person who could realistically use the property, the lessor has not retained any significant ownership interest.

Recent developments in the case law

There have been several recent decisions by the courts relating to the characterization of transactions as leases under pre-safe harbor lease rules. The first of these cases is the Supreme Court decision in *Frank Lyon* v. *United States,*[7] which deals with a sale-leaseback of real property financed by the lessor with cash and recourse debt. In *Frank Lyon,* the Supreme Court held that the transaction was a lease and stated that where there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Among the many factors the court cited for its decision was the fact that there was a business purpose for the sale-leaseback, as evidenced by the fact that State and Federal regulations prohibited the lessee-bank from borrowing a sufficient amount to finance construction, that diversification was the lessor's principal motive, and that the depreciation deductions would have been equally available to the lessee-bank had it retained title. The court also held that the lessee's option to purchase, though fixed, was for a reasonable amount, and that the lessor bore the risk that the lessee would not exercise that option. The facts in *Frank Lyon* indicated that the lessor would realize an overall profit from the transaction independent of tax benefits if the lessee exercised its option to purchase.[8]

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[6] *See, e.g., Northwest Acceptance Corp.* v. *Commissioner,* 58 T.C. 836 (1972), *aff'd,* 500 F. 2d 1222 (9th Cir. 1974).

[7] 435 U.S. 561 (1978), *rev'g,* 536 F.2d 746 (8th Cir. 1976).

Another important decision of dealing with pre-safe harbor lease rules is *Swift-Dodge v. Commissioner.*[9] In *Swift Dodge*, an automobile dealership operated a separate leasing business. The company acquired most of its cars for lease from amounts borrowed from banks on a recourse basis. The auto dealer-lessor obtained a profit from the leases independent of tax benefits. The leases contained a downward adjustment in rent to make up for any difference between the projected value of the property at the end of the lease and the actual value of the property upon lease termination.

The Tax Court held that these nonleveraged transactions were leases and not conditional sales. It cited the general rule that economic substance prevails over form and cited *Frank Lyon* for its statements regarding the necessity of the lessor retaining significant and genuine attributes of the traditional lessor form. It stated that a transaction is a lease if the lessor assumes burdens other than those of a lender and is subject to significant risk not ordinarily incident to a secured loan.

Safe harbor leasing rules

Overview

The safe-harbor leasing provisions of ERTA were intended to permit owners of property who were unable to use depreciation deductions and investment credits to transfer those benefits to persons who were able to use them, without having to meet the pre-safe harbor lease requirements for characterizing the transaction as a lease. The safe-harbor leasing provisions operated by guaranteeing that, for Federal income tax purposes, qualifying transactions were treated as leases, and that the nominal lessor was treated as the owner of the property, even though the lessee was in substance the owner of the property and the transaction otherwise would not have been considered a lease.[10]

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[8] In *Hilton v. Commissioner*, 74 T.C. 305, 348-49 (1980),aff'd., 671 F.2d 316 (9th Cir. 1982), the court, in applying the *Frank Lyon* test to deny lease treatment, stated that the taxpayers must show not only that their participation in a sale-leaseback was not motivated by tax avoidance features that have meaningless labels attached but also that there is economic substance to the transaction independent of the apparent tax shelter potential.

[9] 76 T.C. 547 (1981), rev'd, 82-2 USTC para. 9675 (9th Cir. 1982). After the enactment of the Tax Equity and Fiscal Rsponsibility Act of 1982, the ninth circuit reversed the Tax Court, holding that the transaction was in substance a conditional installment sale with a lump-sum final payment. The court concluded that the only risk borne by the lessor was the risk of default by the lessee, the same risk that would be assumed by the holder of a security interest.

[10] For a discussion of the safe-harbor lease eligibility requirements, see the General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, prepared by the Staff of the Joint Committee on Taxation (December 31, 1982).

Finance leasing rules

Under TEFRA's finance leasing rules, an agreement with respect to certain property may be treated as a lease notwithstanding the fact that (i) the lessee has a right to purchase the property at a fixed price not less than 10 percent of its original cost to the lessor or (ii) the property is of a type not readily usable by a person other than the lessee. No regulations have been issued under the finance leasing provisions.

Except for certain farm property, the finance lease rules apply to agreements entered into after December 31, 1983. However, three transitional rules generally apply. First, no more than 40 percent of certain property placed in service by the lessee during any calendar year beginning before January 1, 1986 may qualify for finance lease treatment. Second, except for property placed in service after September 30, 1985, in taxable years beginning after that date, a lessor may not use the finance lease rules to reduce its tax liability for any taxable year by more than 50 percent. Third, except for property placed in service after September 30, 1985, the investment credit for finance lease property is allowable ratably over 5 years only rather than entirely in the year the property is placed in service.

With respect to certain farm property, the finance lease rules apply to agreements entered into after July 1, 1982, and before January 1, 1984. Furthermore, the 40 percent lessee cap, 50 percent lessor cap, and 5-year spread of investment credit described in the preceding paragraph are generally inapplicable to such farm property.

Reasons for Change

The committee believes that delaying the effective dates of most of the finance lease provisions for 4 years will contribute to reducing budget deficits without having an adverse effect on the economy.

Moreover, the committee reaffirms its belief that transactions treated as leases for Federal income tax purposes should have economic substance independent of the associated tax benefits, as determined by the pre-safe harbor lease rules embodied in existing revenue rulings and revenue procedures of the Internal Revenue Service. The committee also reaffirms its belief that the tax system exists fundamentally to collect tax from taxable entities. It is not meant to be used as a mechanism for making payments to parties, as could happen if transactions structured essentially for the purpose of transferring the benefits of income tax credits and deductions were freely recognized as leases for income tax purposes.

Explanation of Provisions

In general, the effective dates of the finance lease provisions are postponed for 4 years. Thus, except for certain farm property, the finance lease rules will apply only to agreements entered into after December 31, 1987. The three transitional rules currently scheduled to apply during 1984 and 1985 will apply during 1988 and 1989. First, no more than 40 percent of certain property placed in service by the lessee during any calendar year beginning before January 1, 1990 will qualify for finance lease treatment. Second, except for property placed in service after September 30, 1989, in taxable years beginning after that date, a lessor will not be able to use the finance lease rules to reduce its tax liability for any taxable year by more than 50 percent. Third, except for property placed in service after September 30, 1989, the investment credit for finance lease property will be allowable ratably over 5 years only rather than entirely in the year the property is placed in service.

The rules applicable with respect to farm property covered by agreements entered into after July 1, 1982 and before January 1, 1984 are extended for 4 years, to agreements entered into before January 1, 1988.

The Treasury is prohibited from issuing, before January 1, 1988, any regulations generally distinguishing leases from conditional sales agreements or other financing arrangements. However, the Treasury is not prohibited from issuing regulations which may be appropriate under section 210 of TEFRA (relating to agreements covering certain motor vehicles, or under Subtitle B of Title I of the bill (relating to tax-exempt entity leasing).

Effective Date

These provisions are effective March 2, 1984. However, the postponements of the finance lease provisions are not applicable to agreements with respect to property which the lessee had entered into a binding contract to acquire or construct before March 2, 1984. Nor are they applicable to agreements covering property if the property was acquired by, or if construction of the property was begun by or for, the lessee before March 2, 1984.

Revenue Effect

The provisions will increase fiscal year budget receipts by $63 million in 1984, $351 million in 1985, $875 million in 1986, $1,404 million in 1987, $1,445 million in 1988, and $739 million in 1989.

3. Postpone Increases in Amount of Property Eligible for Expensing (sec. 14 of the bill and sec. 179 of the Code)

Present Law

A taxpayer (other than a trust or estate) may elect, in lieu of capital cost recovery under the Accelerated Cost Recovery System (ACRS), to deduct the cost of qualifying property in the taxable year it is placed in service. In general, qualifying property must be acquired by purchase for use in a trade or business and must otherwise be eligible for the investment tax credit. No investment credit is allowable for the portion of the cost of property expensed under this rule.

For taxable years beginning in 1983, the dollar limitation on the amount that can be expensed is $5,000 a year. This limitation is scheduled to increase to $7,500 for taxable years beginning in 1984 and 1985, and to $10,000 for taxable years beginning after 1985. In each case, the limitation that applies to a married individual who files a separate return is one-half the dollar limitation described above.

Reasons for Change

The committee believes that postponement of the scheduled increases will contribute to deficit reduction and will not have adverse economic effects, because the benefits to the taxpayer of claiming the investment credit and recovering costs under ACRS are generally the same in present value as actual expensing.

Explanation of Provision

The bill postpones for four years the scheduled increases in the maximum amount of property that can be expensed. Thus, the dollar limitation on the amount that can be expensed will remain at $5,000 for taxable years beginning before 1988, increase to $7,500 for taxable years beginning in 1988 and 1989, and increase to $10,000 for taxable years beginning after 1989.

Effective Date

The provision is effective with respect to taxable years ending after 1983.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $230 million in 1984, $399 million in 1985, $433 million in 1986, and $386 million in 1987, and to decrease fiscal year budget receipts by $118 million in 1988 and $427 in 1989.

4. Employee Stock Ownership Plans (sec. 15 of the bill and sec. 44G of the Code)

Present Law

Under present law, an employee stock ownership plan ("ESOP") is a tax-qualified plan under which employer stock is held for the benefit of employees. An ESOP under which an employer contributes stock or cash in order to qualify for a credit against income tax liability is referred to as a tax credit ESOP.

Present law permits an electing employer to take an income tax credit for contributions to a tax credit ESOP limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 and 1984, the tax credit is limited to one-half of one percent. With respect to compensation paid or accrued in 1985, 1986, and 1987, the limit is three-quarters of one percent. No credit is provided with respect to compensation paid or accrued after December 31, 1987.

Reasons for Change

The committee believes it is appropriate to maintain the current level of the maximum tax credit for employer contributions to tax credit ESOPs in light of the budget situation.

Explanation of Provision

Under the provision, with respect to compensation paid or accrued in 1985 through 1987, the tax credit for contributions to a tax credit ESOP is limited to one-half of one percent.

Effective Date

This provision of the bill is effective on enactment.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $304 million in 1985, $626 million in 1986, $749 million in 1987, $365 million in 1988, and $64 million in 1989.

5. Limits on Contributions and Benefits under Qualified Pension Plans (sec. 16 of the bill and sec. 415(d) of the Code)

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the overall limits on contributions and benefits under qualified pension, profit-sharing, and stock bonus plans ("qualified pension plans"), tax-sheltered annuity programs, and simplified employee pensions (SEPs). The dollar limit on the annual addition under a defined contribution plan is $30,000, and the dollar limit on the annual benefit payable under a defined benefit plan is $90,000.

TEFRA suspended all cost-of-living adjustments to these dollar limits until 1986. Beginning in 1986, the limits will be adjusted for post-1984 cost-of-living increases under the formula then in effect to provide cost-of-living increases in social security benefits.

Reasons for Change

The committee believes it is appropriate to delay further the cost-of-living adjustments to the dollar limits on contributions and benefits under qualified pension plans, tax-sheltered annuity programs, and SEPs.

Explanation of Provision

Under the provision, the cost-of-living increases to the dollar limits on contributions and benefits under qualified pension plans, tax-sheltered annuity programs, and SEPs would be postponed until 1988.

Effective Date

This provision of the bill is effective on enactment.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $17 million in 1986, $64 million in 1987, $106 million in 1988, and $115 million in 1989.

6. Repeal of Net Interest Exclusion (sec. 17 of the bill and sec. 128 of the Code)

Present Law

Background

In the Economic Recovery Tax Act of 1981 (ERTA), Congress repealed the $200 ($400 on a joint return) interest and dividend exclusion for taxable years beginning after 1981.[11] Congress also established a temporary program of tax-exempt certificates (generally known as All-Savers Certificates). All-Savers Certificates were issuable by qualified savings institutions from September 30, 1981, through December 31, 1982. A lifetime exclusion from gross income of $1,000 ($2,000 in the case of a joint return) of interest earned on qualified tax-exempt certificates was provided.

ERTA also liberalized the requirements governing eligibility for and deductibility of contributions to individual retirement accounts (IRAs).[12]

Net interest exclusion

For taxable years beginning after 1984 (i.e., one year after the expiration of the All-Savers Certificate program), ERTA provided for an exclusion of 15 percent of net interest received up to $3,000 of net interest ($6,000 on a joint return). Net interest is generally defined as eligible interest received by the taxpayer in excess of the amount of interest payments by the taxpayer for which an income tax deduction is allowed.

Reasons for Change

Congress enacted the net interest exclusion for taxable years beginning after 1984 because it believed that a permanent savings incentive based on net savings should replace the temporary All-Savers Certificate program. However, in light of present fiscal restraints the committee believes it would be inappropriate to allow the net interest exclusion to take effect.

The committee continues to believe that savings in the country should be encouraged by tax incentives. On the other hand, revenues lost by those tax incentives will have the effect of increasing Federal deficits. In this regard, revenue losses from the ERTA liberalization of the IRA tax rules have been significantly larger than was originally projected. In light of these unexpectedly large revenue losses, the committee believes that present fiscal restraints counsel against additional tax incentives for savings.

A further problem with the net interest exclusion is that, because it only applies to interest income, it may distort savings incentives away from equity investment and towards debt. In view of the existing incentives for debt finance that result from the deductibility of interest, such a further skewing of investment incentives would be undesirable.

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[11] For subsequent years, the $100 dividend exclusion previously in effect was reinstated, amended to permit an exclusion of up to $200 to be claimed on a joint return without regard to which spouse actually receives the dividend.

[12] *See* ERTA, section 311; H.R. Rep. No. 201, 97th Cong., 1st Sess. 132-37 (1981); S. Rep. No. 144, 97th Cong., 1st Sess. 111-15 (1981).

Accordingly, the committee believes that the net interest exclusion scheduled to take effect in 1984 should be repealed.

Explanation of Provision

The bill repeals the net interest exclusion enacted in ERTA for taxable years beginning after 1984.

Effective Date

This provision of the bill is effective on the date of enactment.

Revenue Effect

This provision will increase fiscal year budget receipts by $1,024 million in 1985, $2,858 million in 1986, $3,100 million in 1987, $3,366 million in 1988, and $3,637 million in 1989.

7. Postpone Increase in Foreign Earned Income Exclusion (sec. 18 of the bill and sec. 911 of the Code)

Present Law

Certain U.S. citizens and resident aliens who live abroad were allowed to exclude from taxable income up to $80,000 of foreign earned income in 1983. Under the Economic Recovery Tax Act of 1981, this amount is scheduled to increase to $85,000 in 1984, to $90,000 in 1985, and to $95,000 in 1986 and thereafter. These individuals also are allowed to exclude or deduct certain foreign housing expenses. The excludable amount does not apply to amounts of foreign income for which the taxpayer elects to claim a foreign tax credit.

Reasons for Change

The committee believes that Americans working abroad help promote the export of U.S. manufactured goods and services. Consequently, the committee wishes to retain an exclusion from taxable income for a substantial amount of foreign earned income. However, the committee believes that delaying increases in the amount of the foreign earned income exclusion will have no important effect on U.S. exports, but will make a contribution in reducing Federal budget deficits. Reducing budget deficits should improve the United States' balance of trade.

Explanation of Provision

The bill holds the maximum foreign earned income exclusion at its 1983 level of $80,000 per year until taxable years beginning in 1988, when this limit increases to $85,000. The limit will increase to $90,000 in taxable years beginning in 1989 and to $95,000 in taxable years beginning in 1990 and thereafter.

Effective Date

The provision is effective on the date of enactment and will reduce the excludable amount to $80,000 for the entire calendar year 1984.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $4 milion in 1984, $31 million in 1985, $80 million in 1986, $106 million in 1987, $107 million in 1988, and $79 million in 1989.

8. Defer scheduled reductions in maximum gift and estate tax rates (sec. 21 of the bill and secs. 2001 and 2502 of the Code)

Present Law

The Economic Recovery Tax Act of 1981 (ERTA) enacted reductions in the maximum gift and estate tax rates, to take effect over a four-year period. The maximum rate before ERTA was 70 percent. Under ERTA, the maximum rates are 60 percent for gifts made and decedents dying in 1983; 55 percent, in 1984; and 50 percent thereafter.

Reasons for Change

The committee believes that current budgetary contraints render it appropriate to postpone reductions in the maximum gift and estate tax rates beyond the level reached in 1983 until 1988.

Explanation of Provision

Under the bill, the maximum gift and estate tax rate will be 60 percent for gifts made and individuals dying in 1984 through 1987. The rate will be reduced to 55 percent in 1988 and to 50 percent in 1989.

Effective Date

This provision of the bill is effective for gifts made, and estates of individuals dying, after December 31, 1983.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than $5 million in 1984, $129 million in 1985, $399 million in 1986, $503 million in 1987, $578 million in 1988, and $439 million in 1989.

9. Windfall Profit Tax on Newly Discovered Oil (sec. 25 of the bill and sec. 4987(b))3) of the Code)

Present Law

Present law imposes an excise tax on the production of domestic crude oil. Differing tax rates and base prices apply to oil, generally depending upon its classification on one of three tiers.

Tier 1 oil (previously controlled oil) generally is taxed at a 70-percent rate; tier 2 oil generally is taxed at a 60-percent rate. A fifty-percent rate applies to up to 1,000 barrels a day of tier 1 oil production by independent producers. In the case of tier 2 oil (stripper oil), production by independent producers generally is exempt from tax.

Tier 3 oil is newly discovered oil, heavy oil, and incremental tertiary oil. Prior to 1982, all tier 3 oil was subject to tax at a 30-percent rate. Starting in 1982, the rate on newly discovered oil was reduced to 27½ percent and to 25 percent in 1983. Under present law, the rate of windfall profit tax on newly discovered oil is 22-1/2 percent for 1984, 20 percent for 1985, and 15 percent for 1986 and later years. At current price levels, the windfall profit tax on a typical barrel of newly discovered oil would be approximately $1.25 at the 25 percent rate.

Reasons for Change

The committee believes that the rate of tax on newly discovered oil should be frozen at its 1983 level in connection with its general freeze on other tax reductions.

Explanation of Provision

Under the bill, the rate of windfall profit tax on newly discovered oil would not be reduced to 22½ percent in 1984. Instead, the rule would remain at 25 percent through 1987 and then be reduced to 22½ percent for 1988, 20 percent for 1989, and 15 percent for 1990 and later years.

Effective Date

This provision of the bill applies with respect to domestic crude oil removed from the premises on which it was produced after December 31, 1983.

Revenue Effect

The provision is expected to increase fiscal year budget receipts by $15 million in 1984 and $15 million in 1985.

10. Percentage depletion for Secondary and Tertiary Production after 1983 (sec. of the bill and sec. 613A(c) of the Code)

Present law

In the Tax Reduction Act of 1975, Congress retained the percentage depletion allowance for limited quantities of oil and gas production. For oil production, effective January 1, 1984, the rate has declined to a permanent level of 15 percent and is limited to 1,000 barrels per day.

The 1975 amendment continued this percentage depletion allowance for secondary and tertiary production at a 22 percent rate but (because of an error that all parties agree was not intended) only through 1983. Also, a special rule reduces the depletable oil amount by any secondary or tertiary production. Therefore, a producer's depletable quantity of primary production will be reduced by any secondary or tertiary production even though percentage depletion is not available for such production.

Under the 1975 amendments, if an interest in any proven oil or gas property is transferred to another owner after 1974, no percentage depletion allowance applies to the property after the transfer. The proposed Treasury regulations, published in 1977, stated that the transfer restrictions would not apply to percentage depletion for secondary and tertiary production. This exception to the transfer rule resulted from the same 1975 drafting error that caused termination of that percentage depletion after 1983.

Reasons for Change

The committee wishes to correct the technical errors made in the Tax Reform Act of 1975.

Explanation of Provision

The bill would correct the technical errors that occurred in the Tax Reform Act of 1975 with respect to depletion on secondary and tertiary depletion. The bill would eliminate the distinction between primary and secondary or tertiary production after 1983. Thus, independent producers could claim percentage depletion in 1984 at a rate of 15 percent on up to 1,000 barrels of all their production. In addition, starting in 1984, percentage depletion on secondary and tertiary production would not be available after 1983 for production from properties transferred since 1974.

Revenue Effect

The amendment would have no effect on revenues.

11. Modification of Excise Tax Rates on Cigarettes and Distilled Spirits (sec. 27 of the bill and secs. 5001 and 5701 of the Code)

Present Law

Cigarette excise tax

An excise tax is imposed on cigarettes manufactured in or imported into the United States (sec. 5701). The tax is determined when the cigarettes are removed from the factory or released from customs custody. The present rate of tax on small cigarettes is $8 per thousand (i.e., 16 cents per pack of 20 cigarettes). The tax rate on large cigarettes generally is $16.80 per thousand; proportionately higher rates apply to large cigarettes that exceed 6.5 inches in length. Small cigarettes are cigarettes weighing no more than 3 pounds per thousand; large cigarettes are cigarettes weighing more than 3 pounds per thousand. Nearly all taxable cigarettes are small cigarettes.

On October 1, 1985, the present cigarette excise tax rates are scheduled to decrease to $4 per thousand (i.e., 8 cents per pack of 20 cigarettes) and to $8.40 per thousand for large cigarettes.

Distilled spirits excise tax

An excise tax is imposed on distilled spirits manufactured in or imported into the United States (sec. 5001). The tax is determined when the distilled spirits are removed from the distillery or released from customs custody.

The present rate of tax on distilled spirits is $10.50 per proof gallon. A proof gallon of distilled spirits is defined as a U.S. gallon of liquid one-half of the volume of which consists of ethyl alcohol of a specified gravity. The present distilled spirits tax rate produces a tax of $2.10 on a fifth of 100-proof spirits and a tax of $1.68 on a fifth of 86-proof spirits.

Reasons for Change

Before 1982, the excise tax on cigarettes had not been increased since 1951. The present tax on distilled spirits has not been increased since 1951. These taxes are imposed as flat, set amounts; therefore, their effective rates diminish as a result of inflation. Congress believed in 1982 that doubling the cigarette tax would not unduly burden that industry because of the decrease in the effective tax rate that had occurred since 1951. However, the increased rate was made effective only through September 30, 1985, to permit a review of the impact of the higher rates.

The committee believes that the present budgetary situation requires continuation of the revenues produced from increased cigarette excise tax rate for an additional two years. However, after reviewing the 1982 increase in the cigarette excise tax rates, the committee determined that the cigarette tax should be extended at a lower rate than that enacted for the period 1982 through 1985. Therefore, the committee has included a 12-cents-per-pack rate for the period October 1, 1985 through December 31, 1987.

The committee further determined that it is appropriate to increase the excise tax on distilled spirits by $3.75 per proof gallon. The distilled spirits tax is increased only by an amount which results in this provision of the bill being revenue neutral when compared to an extension of the full increase in the cigarette tax that was enacted in 1982. This increase produces less than a 36-percent increase over the present level of the distilled spirits tax, a percentage below the 50-percent increase that will continue to be paid over the pre-1983 rate applicable to cigarettes. Further, because of the effect of inflation since 1951, the new effective tax rate for distilled spirits will remain substantially below the effective rate immediately after the last increase in that tax in 1951.

Explanation of Provision

1. Cigarette excise tax

Tax rate

The bill provides an excise tax rate of $6 per thousand on small cigarettes, which is equal to a tax rate of 12 cents per pack of 20 cigarettes. The tax rate on large cigarettes not exceeding 6.5 inches in length will be $12.60 per thousand. (Proportionately higher rates will apply to large cigarettes that exceed 6.5 inches in length.) These new rates will be effective for the period October 1, 1985 through December 31, 1987.

Floor stocks refunds

In general.—The bill also includes provisions generally providing for refunds of tax with respect to cigarettes held for sale on October 1, 1985, on which tax at the higher rate imposed before that date is paid. These floor stocks refunds will be equal to the reduction in tax on cigarettes provided by the bill (e.g., 4 cents per pack of 20 cigarettes for small cigarettes). The term cigarettes held for sale includes promotional cigarettes, but not cigarettes in the process of withdrawal from the market on October 1, 1985.

Floor stocks refunds will be paid to manufacturers and importers who originally paid tax on the cigarettes involved. To be eligible for a refund, a manufacturer (including an importer) must submit a claim to the Bureau of Alcohol, Tobacco, and Firearms before July 1, 1986.[13] The manufacturer must have commercial records to substantiate the claim that he paid the tax on the cigarettes to which the claim relates.[14] The manufacturer also must (1) reimburse wholesale distributors in an amount equal to the amount of the refund[15] with respect to cigarettes held on October 1, 1985, for sale by the wholesale distributors, or (2) absent such a payment to the wholesale distributor, must obtain the distributor's written consent to the manufacturer's or importer's receiving the floor stocks refund. The manufacturer or importer must receive the written consent or possess commercial records evidencing reimbursement of the wholesale distributor before (or simultaneous with) the time any payment is made or credit granted by the Treasury Department.[16]

1988 floor stocks refunds.—The bill provides for additional floor stocks refunds with respect to cigarettes held for sale on January 1, 1988. These refunds will be available under rules like those that apply to the 1985 refunds.

2. Distilled spirits tax

Tax rate

The bill increases the tax rate on distilled spirits from $10.50 per proof gallon to $14.25 per proof gallon for the period after September 30, 1985, and before January 1, 1988.

Floor stocks taxes and refunds

In general.—The bill also includes provisions extending the increased rate of tax on distilled spirits to certain floor stocks. Under the bill, an additional tax generally is imposed on distilled spirits held for sale on October 1, 1985, which distilled spirits were removed from bonded premises before that date, and a tax at the pre-October 1, 1985 rate imposed at the time of such removal. The additional tax is equal to $3.75 per proof gallon. This tax is to be collected from the person holding the distilled spirits on October 1, 1985, as if the distilled spirits were removed from bonded premises on that date. The additional tax is treated as if it were a tax imposed under Code section 5001 (or sec. 7625). The tax will be due on a date, not later than March 31, 1986, to be established under Treasury Department regulations.

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[13] To be eligible for a floor stocks refund, wholesale distributors must file a claim before April 1, 1986, with manufacturers and importers from whom they purchase cigarettes. This claim must reflect floor stocks refunds due to such distributors and to customers of distributors.

[14] The committee intends that the commercial records regularly maintained by manufacturers, importers, and wholesale distributors generally will be sufficient record to substantiate claims for floor stocks refunds. However, the Bureau of Alcohol, Tobacco, and Firearms is authorized to require physical inventories of products held on October 1, 1985 in any case where it determines that such an inventory is necessary to ensure compliance with the law.

[15] This reimbursement may be in cash, by credit to a pre-existing account, or in kind.

[16] Wholesale distributors must reimburse their customers or obtain written consent as a condition of receiving any payment from a manufacturer or importer with respect to cigarettes not actually held by the distributors on October 1, 1985.

Exemption for certain on-premises retail establishments.—The bill authorizes the Treasury Department, by regulation, to exempt from the floor stocks tax limited quantities of distilled spirits held by any person exclusively for sale and on-premises consumption on October 1, 1985. The committee intends that this exemption not apply in the case of any person holding 400 or more liters of such spirits.

Effective Dates

These provisions are effective for the period October 1, 1985 through December 31, 1987.

Revenue Effect

The provisions with respect to cigarette and distilled spirits excise taxes are estimated to increase fiscal year budget receipts by $1,773 million in 1986, $1,914 million in 1987, and $835 million in 1988.

12. Extension of Telephone Excise Tax (sec. 26 of the bill and sec. 4251 of the Code)

Present Law

A 3-percent excise tax is imposed on amounts paid for local telephone service, toll telephone service, and teletypewriter exchange service (sec. 4251). The tax is paid by the person who pays for service to the person rendering the service, who in turn remits the tax to the general fund of the Treasury.

Exemptions from the tax are provided for communications services furnished to news services (except local telephone service to news services), international organizations, the American National Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations, and State and local governments. Other exemptions include amounts paid for installation charges and for certain calls from coin-operated telephones (sec. 4253).

This excise tax is scheduled to terminate, effective with respect to amounts paid pursuant to bills first rendered on or after January 1, 1986.

Reasons for Change

The committee determined that continuation of the telephone excise tax at the present rate is appropriate at this time due to the existing budgetary deficit situation. This excise tax has been in effect since 1941; the tax rate was 10 percent until 1973. In the past, the tax has typically included an expiration date; however, before each scheduled expiration, Congress has found it necessary to extend the tax because of revenue needs.

Explanation of Provision

The bill extends the current 3-percent telephone excise tax rate for two years, calendar years 1986 and 1987.

Effective Date

The 3-percent rate is extended to amounts paid pursuant to telephone bills rendered on or after January 1, 1986, through December 31, 1987.

Revenue Effect

This provision will increase net fiscal year budget receipts by $1,168 million in 1986, $2,016 million in 1987, and $803 million in 1988.

B. Tax-Exempt Entity Leasing

A. Present Law

Summary

Under present law, the rules for determining who is entitled to the tax benefits associated with the ownership of property generally are not written in the Internal Revenue Code. Rather, they are embodied in a series of court cases and revenue rulings and revenue procedures issued by the IRS. Essentially, these rules focus on the economic substance of a transaction, not its form, for determining who is entitled to the tax benefits of the ownership of property. Thus, in a purported lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

In general, the tax benefits of ownership of tangible property include depreciation or accelerated cost recovery deductions and investment tax credits. Generally, ACRS or other depreciation deductions and investment credits are allowed only for property used for a business or income-producing purpose. The accelerated cost recovery system generally permits taxpayers to depreciate qualifying property on an accelerated basis over relatively short periods. For most property, the ACRS recovery period is shorter than the actual useful life of the property. Investment credits permit taxpayers to reduce their tax liability by a percentage of their investment in eligible property. Eligible property includes certain depreciable personal property. Additional investment credits are available for certain energy property and to certain improvements to buildings at least 30 years old.

As a general rule, governmental units and tax-exempt organizations are not entitled to depreciation deductions or investment credits for property owned by them. Moreover, no investment credit is allowed for property used (though not owned) by a tax-exempt organization in its exempt function or by a governmental unit (nontaxable use restriction). The nontaxable use restriction does not affect the allowance of ACRS deductions and certain other tax benefits.

Property used by a foreign government or person is not subject to the nontaxable use restriction. However, if the property is used predominantly outside the United States (foreign-use property), then, in general, ACRS deductions are reduced and no investment credit is allowed.

The traditional reasons for leasing stem from tax, accounting, and a variety of business considerations. Tax-exempt organizations and governmental units have leased equipment for many of the same reasons as taxable entities. The recent increase in leasing and similar arrangements is due, in part, to budgetary limitations on the purchase of property and, in the case of some State and local governments, limitations on their ability to issue tax-exempt bonds. From a tax perspective, leasing allows certain tax benefits (such as ACRS deductions) to flow through (in the form of reduced rents) to nontaxable entities that are not eligible for such benefits on their own account. In some cases, the reasons for arranging a transaction with a nontaxable entity as a service contract or in some other form stem from a desire to avoid the nontaxable use restriction on the investment credit.

What follows is a description of the present-law rules governing the determination of ownership of property for Federal income tax purposes, in the context of leases or similar arrangements, and a description of the nontaxable use restriction on the investment credit. The rules governing ACRS and the investment credit for foreign-use property are also discussed.

The ownership issue

Overview

The determination of the Federal income tax ownership of property requires a case-by-case analysis of all facts and circumstances. Although the determination of ownership is inherently factual, a number of general principles have been developed in court cases, revenue rulings, and revenue procedures.

In general, both the courts and the IRS focus on the substance of the transaction rather than its form. The courts do not disregard the form of a transaction simply because tax considerations are a significant motive, so long as the transaction also has a bona fide business purpose and the person claiming tax ownership has sufficient burdens and benefits of ownership.

In general, for Federal income tax purposes, the owner of property must possess meaningful burdens and benefits of ownership. The lessor must be the person who suffers, or benefits, from fluctuations in the value of the property. Thus, lease treatment is denied, and the lessee is treated as the owner, if the lessee has the option to obtain title to the property at the end of the lease for a price that is nominal in relation to the value of the property at the time the option is exercisable (as determined at the time the parties entered into the agreement) or which is relatively small when compared with the total lease payments to be made.

Where the lessor's residual value in the property is nominal, the lessor is viewed as having transferred full ownership of the property for the rental payments. Where the purchase option is more than nominal but relatively small in comparison with fair market value, the lessor is viewed as having transferred full ownership because of the likelihood that the lessee will exercise the option. Furthermore, if the lessor has a contractual right to require the lessee to purchase the property at the end of the lease (a put), the transaction could be denied lease treatment because the put eliminates the lessor's risk of loss in value of the residual interest and the risk that there will be no market for the property at the end of the lease.

Objective guidelines used in structuring transactions

To give taxpayers guidance in structuring leveraged leases (i.e., leases in which the property is financed by a nonrecourse loan from a third party) of equipment, the IRS issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines are met and if the facts and circumstances do not indicate a contrary result, the IRS generally will issue an advance letter ruling that the transaction is a lease and that the lessor is the owner for Federal income tax purposes.

The guidelines are not by their terms a definitive statement of legal principles and are not intended for audit purposes. Thus, if all the requirements of the guidelines are not met, a transaction might still be considered a lease if, after considering all facts and circumstances, the transaction is a lease under the general principles described above.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. *Minimum investment.*—The lessor must have a minimum 20 percent unconditional at-risk investment in the property.
2. *Purchase options.*—In general, the lessee may not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). That rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the exercise date.
3. *Lessee investment precluded.*—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property.
4. *No lessee loans or guarantees.*—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any loan to the lessor.
5. *Profit and cash flow requirements.*—The lessor must expect to receive a profit and have a positive cash flow from the transaction independent of tax benefits.
6. *Limited use property.*—Under Revenue Procedure 76-30, 1976-2 C.B. 647, property that can be used only by the lessee (limited use property) is not eligible for leveraged lease treatment.

Nontaxable use restriction on the investment credit

General rule

Property that is "used by" a tax-exempt organization in an exempt function or by a governmental unit generally is ineligible for the investment credit (secs. 48(a)(4) and 48(a)(5)), including the investment credit for energy property. For this purpose, a governmental unit includes the United States government, any State or local government, most international organizations, and any instrumentality of the foregoing. A tax-exempt organization is almost any organization exempt from Federal income tax, such as a charitable or educational organization.

To determine whether property is subject to the nontaxable use restriction, it is first necessary to evaluate the economic substance of the transaction under the general principles for determining who is the tax owner of property.[1]

Under the nontaxable use restriction, the investment credit is unavailable with respect to property that is treated for Federal income tax purposes as being owned by a governmental unit or a tax-exempt organization for use in its exempt function. In addition, property leased to a governmental unit or a tax-exempt organization for use in its exempt function is generally subject to the nontaxable use restriction. However, in addition to several statutory exceptions to the nontaxable use restriction, one court has held (and the IRS has ruled) that the investment credit can be claimed where the governmental unit essentially has contracted for a service, to be provided by the owner of property, rather than for the use of the property itself.

Statutory exceptions to the nontaxable use restriction

Tax-exempt organizations.—Under present law, certain farmers' cooperatives (which are considered exempt from tax even though they are subject to the rules of subchapter T, relating to cooperatives and their patrons) are excluded from the restriction on use by a tax-exempt organization. Also, the credit is allowed for property used by a tax-exempt organization in a taxable unrelated trade or business.

Foreign governmental units.—Although international organizations generally are subject to the restriction, property used by the International Satellite Consortium, the International Maritime Satellite Organization, and any successor organizations is excluded from the restriction on governmental use. Foreign governments and possessions of the United States are not subject to the restriction. Thus, a computer leased to the United States Government is denied the credit, but a computer leased to a foreign embassy located in the United States is allowed the credit.

Rehabilitated buildings.—Under present law, rehabilitation tax credits are available for qualified rehabilitation expenditures incurred for older buildings leased to tax-exempt organizations or to governmental units.

Foreign persons.—Property used by foreign persons is not subject to the nontaxable use restriction. However, special rules (discussed below) apply if the property is used predominantly outside the United States.

"Casual or short-term lease" exception

Under Treasury regulations, there is an exception to the nontaxable use restriction for property that is leased on a "casual or short-term basis" (Treas. Reg. sec. 1.48-1(j) and (k)).

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[1] Rev. Rul. 68-590, 1968-2 C.B. 66. Revenue Ruling 68-590 involved arrangements between a taxable corporation and a political subdivision of a State providing for the tax-exempt financing, construction, and operation of an industrial project. The IRS did not apply the nontaxable use restriction even though the governmental unit held legal title under a sale-and-leaseback. Rather, the IRS held that the corporation was the tax owner of the property. The IRS reasoned that, in view of the economic substance of the arrangement, the sale-leaseback arrangement was nothing more than a security device for the protection of the holders of the tax-exempt bonds.

Casual leases.—The term "casual lease" has been interpreted to mean a lease that lacks the formalities inherent in a written lease.[2] Another example of a casual lease might be the lease of an automobile from a car rental company by a governmental employee traveling on governmental business.[3]

Short-term leases.—The exception for short-term leases has been recognized as a means of allowing the government to fulfill an unforeseen or extraordinary need for obtaining the short-term use of property from the private sector, without causing the taxpayer to lose the credit.[4] Thus, property not ordinarily intended for lease to a tax-exempt organization or governmental entity may be leased under the exception for a short period in unforeseen or extraordinary circumstances.

In determining whether the exception for short-term leases applies, the courts have rejected the contention that the relevant consideration is whether the nonqualifying use constitutes a substantial portion of the useful life of the property.[5] The courts have also rejected the position that short-term use should be determined on the basis of the minimum legally enforceable period of a lease.[6]

"Service contract" exception

Internal Revenue Service rulings.—Under Treasury regulations (sec. 1.48-1(j) and (k)), property used by a governmental unit or tax-exempt organization means property owned by or leased to one of those nontaxable entities. In Revenue Ruling 68-109, 1968-1 C.B. 10, the IRS ruled that property provided to a governmental unit as an integral part of a service is not "used by" the government within the meaning of section 48(a)(5).

Revenue Ruling 68-109 involved communications equipment installed by a public utility on the premises of governmental units. In ruling that the taxpayer's agreements with its customers were not sales or leases, but rather service contracts, the IRS relied on the fact that the taxpayer retained all ownership in and possession and control over the equipment. The IRS also focused on the fact that the communications equipment was part of an integrated network used to render services to the customer, not property placed with a user to allow it to provide services to itself.

The IRS has issued a number of other rulings, including private rulings,[7] interpreting the service contract exception. For example, the investment credit has been denied in situations involving trucks operated under a service contract by government employees (Rev. Rul. 72-407, 1972-2 C.B. 10) and school buses operated by a private party under contract with a local school district (LTR 8104001 (February 27, 1980)). However, in LTR 8217040 (January 27, 1982), the IRS allowed the investment credit in a situation involving a time charter of a vessel to the Federal government. The IRS ruled that the taxpayer could claim an investment credit for the vessel based on the taxpayer's representations that the taxpayer bore the risk of loss with respect to the vessel, the taxpayer had to retain possession and control over the vessel, the taxpayer was required to provide maintenance and secure insurance for the vessel, the taxpayer had to furnish and control the crew of the vessel, and the time charter transferred no legal interest in the property to the Federal government.

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[2] See, *Xerox Corporation v. United States*, 656 F.2d 659 (Ct. Cl. 1981).

[3] *Id.*

[4] *World Airways, Inc. v. Commissioner*, 564 F.2d 886 (9th Cir. 1977), *aff'g* 62 T.C. 786 (1974).

[5] *World Airways Inc. v. Commissioner*, 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977).

[6] Thus, the mere fact that a lease contains a cancellation clause will not result in application of this exception. *Xerox Corporation v. United States*, 656 F.2d 659 (Ct. Cl. 1981); *Stewart v. U.S.*, 77-2 U.S.T.C. 9648 (D. Neb. 1977).

[7] Although a private ruling is not binding as precedent on the IRS with respect to taxpayers other than the taxpayer who received the ruling, or the courts, a private ruling is helpful in interpreting the law in the absence of other authority.

The case law.—The only judicial decision dealing with the service contract exception to the nontaxable use restriction is *Xerox Corporation* v. *United States*, 656 F.2d 659 (Ct. Cl. 1981). In *Xerox*, a manufacturer provided duplicating machines to the Federal government. The IRS had issued a revenue ruling involving the same basic facts as in *Xerox* that held that the agreements were leases (Rev. Rul. 71-397, 1971-2 C.B. 63). The Court of Claims rejected the taxpayer's contention that its agreements were short-term leases, which are eligible for an exception to the governmental use restriction. However, the court held that the machines were eligible for the investment credit because they were provided as an integral part of a service contract.

Essentially, the Court of Claims based its decision on the IRS's own formulation of the service contract exception, as set forth in the holdings of published and private rulings (other than Rev. Rul. 71-397). The court rejected the government's contention that the service contract exception cannot ever apply where the customer's own personnel operate the machines, because this factor was present in the first ruling adopting the exception (i.e., Rev. Rul. 68-109). The court emphasized that *Xerox* was not a case in which the cost or value of the property dominated the price of the total arrangement. The court also noted that, conceivably, its decision would have been different if the Treasury regulations had formulated the precise confines of the service contract exception.

Although the published and private rulings do not articulate any single test for use in determining whether an agreement is a service arrangement or a lease, the court felt that the factors deemed common to service contracts in those rulings related to two broad areas of inquiry: (1) the nature of the possessory interest retained by the taxpayer and (2) the degree to which the property supplied is a component of an integrated operation in which the taxpayer has other responsibilities.

In holding that the interest conveyed to the customer was not sufficient to constitute a leasehold interest, the *Xerox* court focused on the following factors drawn from the IRS rulings in which a service contract was held to exist: (1) the taxpayer retained ownership of the machines, (2) the taxpayer decided whether to repair, replace, or alter the machines, and the customer was prohibited from altering or moving the machines, (3) the taxpayer bore the cost of adjustments, repairs, and replacements, (4) the taxpayer was responsible for loss or damage, except in the case of the customer's negligence, and (5) the customer could cancel upon 15 days notice.

Finally, in holding that the taxpayer's contractual arrangements could reasonably be deemed to be within the purpose of the investment credit, the court focused on the fact that the taxpayer manufactured machines for all customers, not just the government, and that governmental use represented only 5 or 6 percent of the taxpayer's machines.

Foreign-use limitations

Overview

Property "used predominantly outside the United States" is subject to reduced ACRS deductions and is not allowed the investment credit (secs. 168(f)(2) and 48(a)(2)).

In general, property "used predominantly outside the United States" means property used outside the United States for more than half of the taxable year. However, there are a number of exceptions to this general rule. For example, communications satellites are excepted from the rules for foreign-use property. U.S.-flag vessels operated in the foreign or domestic commerce of the United States are excepted, as are aircraft registered by the Federal Aviation Agency and operated to and from the United States[8] or operated under contract with the United States, even if operated by a foreign airline. Special rules are also provided for certain rolling stock, drilling rigs, motor vehicles, containers, submarine cable, and other property.

ACRS deductions

The recovery period for computing ACRS deductions for recovery property used predominantly outside the United States is equal to the present class life (mid-point life) for the property, as of January 1, 1981, under the prior law ADR system. For personal property for which there is no ADR mid-point life as of January 1, 1981, a 12-year recovery period must be used. The determination of useful lives based on facts and circumstances is not permitted. The owner of foreign-use personal property generally is allowed to use the 200-percent declining balance method of depreciation for the early years of the recovery period and the straight-line method for later years.

For foreign real property (including all components of a building), the recovery period is 35 years. The owner of foreign real property is generally allowed to use the 150-percent declining balance method for the early years of the recovery period, switching to the straight-line method in later years.

In the case of foreign-use personal property or foreign real property, the straight-line method of depreciation can be used in lieu of the prescribed accelerated methods. In addition, for foreign-use personal property, the taxpayer may elect the straight-line method over one of the longer recovery periods allowed for domestic property (but the period elected may not be shorter than the ADR mid-point life, or, for property without an ADR mid-point life as of January 1, 1981, 12 years). For foreign real property, the taxpayer may elect to use the straight-line method over a recovery period of 45 years (instead of 35 years).

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[8] The IRS has ruled that a plane returning to the United States only once every two weeks qualifies as being operated to and from the United States. Rev. Rul. 73-367, 1973-2 C.B. Furthermore, an airplane can be leased for temporary use outside the United States without any investment credit recapture. Under section 47(a)(7)(A), 3 1/2 years qualifies as temporary use for this purpose.

B. Reasons For Change

Overview

The committee believes that reform of the tax law is essential, insofar as it relates to property used by tax-exempt entities under a lease, a lease formulated as a service contract, or other similar arrangements. When tax-exempt entities use property under these arrangements, they pay reduced rents that reflect a pass-through of investment tax incentives from the owner of the property. Tax-exempt entities thereby benefit from investment incentives for which they do not qualify directly, and effectively gain the advantage of taking income tax deductions and credits while having no corresponding liability to pay any tax on income from the property. In this way, investment incentives that were intended to reduce the tax on taxable entities have been turned into unintended benefits for tax-exempt entities, including foreign entities. The benefits are equivalent to an open-ended spending program, operated within the tax system, that increases the Federal deficit, encourages tax-exempt entities to dispose of the assets they own and forego control over the assets they use, disorders public budgeting processes, and feeds a popular perception that the tax system is open to manipulation.

The committee is greatly concerned about these problems, the scale of which has been magnified by the recent surge in leasing to tax-exempt entities and other arrangements devised to transfer tax benefits to them. In response, the committee bill restricts tax benefits for property used by tax-exempt entities so that the Federal tax outflow will be eliminated and tax-exempt entities will be able to lease property on the same tax-free basis as they can purchase it.

Background

In 1962, Congress first enacted the investment tax credit for certain property used in a trade or business or for the production of income. The purpose of the credit is to reduce the income tax liability of taxpayers and thereby encourage their purchase and use of capital goods. When enacting the investment credit, Congress expressly disallowed it for property used by governmental units and tax-exempt organizations, which of course have no income tax liability to reduce. However, the provision was necessary to prevent these tax-exempt entities from indirectly gaining—through leasing, for example—the benefits of both tax-exemption and the income tax credit. This policy has been continued to the present. It is grounded in the fundamental principle that the tax system exists to collect from taxable entities, not to make payments to tax-exempt entities.

The committee believes that the policy of providing tax-reducing incentives to those who are subject to the income tax and denying them to those who are not subject to the income tax should be maintained, and that three major amendments are needed to improve its application. The amendments relate to (a) accelerated depreciation deductions, (b) transactions structured to avoid the present denial of the investment credit, and (c) the treatment of foreign tax-exempt entities.

Accelerated depreciation deductions

Over the last two decades, Congress has acted to accelerate cost recovery (depreciation) deductions for property used in a trade or business or for the production of income. The introduction of the Asset Depreciation Range System in 1971 and the enactment of the Accelerated Cost Recovery system in 1981 were two significant steps in this direction. The purpose of accelerating cost recovery deductions is to reduce the income tax liability of taxpayers in order to encourage their purchase and use of capital goods. Taking into account the time value of money, accelerated deductions reduce the present value of tax to be paid by deferring payment to later years.

The cumulative effect of legislation relating to cost recovery allowances is that these deductions currently operate, like the investment credit, as a significant investment incentive, by reducing the value of the tax that would otherwise be imposed on the investment. However, present law does not generally deny the benefits of accelerated cost recovery for property leased to tax-exempt entities. As a result, the transfer of benefits to these entities through the tax system that Congress acted to prevent with respect to the investment credit is now occurring due to accelerated depreciation deductions. Therefore, the committee bill provides for less rapid write-offs of property used by tax-exempt entities, such that the Federal tax outflow will be eliminated and tax-exempt entities will be able to lease property on the same tax-free basis as they can purchase it.

Transactions structured to avoid investment credit restrictions

The committee understands that the value of the investment credit is sufficiently great to have prompted more attempts to structure transactions in a form other than a lease, such that property used by a tax-exempt entity or dedicated primarily to its use will nevertheless qualify for the credit. The committee is concerned that Congress has not provided statutory guidance for determining when property is in substance used by a tax-exempt entity. Therefore, the committee bill provides criteria for this purpose, so that the economically insubstantial restructuring of a lease as a service contract or similar arrangement will not result in unintended, preferential tax treatment.

Foreign tax-exempt entities

The present law denial of investment credit for property used by tax-exempt entities is incomplete because it does not apply to substantial amounts of certain types of property which are leased by foreign governments and other foreign persons who are not subject to Federal income tax. As a result, this property qualifies for greater tax benefits than property leased to the Federal government, State or local governments, or domestic organizations which also are not subject to Federal income tax.

The committee believes that tax benefits for property used by foreign tax-exempt entities should not exceed tax benefits for property used by domestic tax-exempt entities. The committee is unconvinced that the current preferential treatment for foreign lessees of certain equipment should be maintained as an export subsidy. First, the current benefits are available without regard to whether the equipment was produced in the United States. Thus, the Federal government contributes to the foreign manufacture and use of equipment which is owned by a U.S. lessor. Second, the impact of the current tax benefits in stimulating exports is diluted to the extent that they are retained by the lessor, rather than being flowed through to the foreign lessee as reduced financing costs. Third, to the extent that financing costs are reduced for the foreign lessee (which could be tax-exempt in its home country), they provide lower prices to foreign businesses for goods or services which may be in direct competition with U.S. businesses. Fourth, preferential tax benefits for foreign governments to lease equipment would place them in a more favorable position than to State and local governments. Fifth, the committee is aware that direct credit assistance is available for exporters of U.S.-produced goods through the Export-Import Bank. Therefore, the committee bill does not except foreign lessees from the general policy of subsidy-free tax treatment for property used by tax-exempt entities.

The committee is aware that the United States has entered into treaties that, on a reciptocal basis, exempt residents of the treaty partner from U.S. tax on certain shipping and aircraft income. However, those provisions do not in any way guarantee to residents of those countries the benefits of the investment tax credit or any accelerated depreciation regime.

Additional reasons

The committee has additional reasons for believing that the tax benefits (in excess of tax exemption itself) currently available to tax-exempt entities through leasing should be eliminated.

First, the Federal budget is in no condition to sustain the substantial revenue loss resulting from leasing to tax-exempt entities, which will certainly increase as more tax-exempt entities, financial entities, and tax-oriented investors learn how to take advantage of the tax system in that way. Nothing is accomplished to reduce budget deficits when spending cuts are matched or exceeded by revenue losses. These losses are especially large in transactions involving debt-financed property.[9]

Second, the committee is concerned about possible problems of accountability of governments to their citizens, and of tax-exempt organizations to their clienteles, if substantial amounts of their property should come under the control of outside parties solely because the Federal tax system makes leasing more favorable than owning. The committee is convinced that the tax system should not encourage tax-exempt entities to dispose of the assets they own or to forego control over the assets they use.

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[9] With respect to tax benefits for debt-financed property, see Joint Committee on Taxation staff pamphlet, "Description of S. 1564 Relating to Tax Treatment of Property Leased to Tax-Exempt Entities" (JCS-34-83).

Third, the committee believes that Federal aid to tax-exempt entities (above and beyond their tax exemption) should be made by appropriations rather than by tax benefits transferred through the tax system. The tax benefits in leasing are open-ended and hence uncontrollable in amount and composition, whereas appropriations are limited and adjustable to current priorities from year to year. Moreover, tax benefits appear in the Federal budget only as reduced tax collections, unassociated with any particular public purpose. Thus, with Federal aid conveyed through the tax system, it is very difficult to discover what tax-exempt purposes have been federally assisted, by how much they have been assisted, and whether the assistance has been rendered in ways consistent with other objectives of public policy. These matters can be known, debated, and decided in the appropriations process.

Fourth, the committee is concerned about waste of Federal revenues. Although under present law tax benefits exist to be shared by the tax-exempt user of property and the taxable owner, there is no assurance that the tax-exempt entity will be the prime beneficiary. For example, when a substantial portion of the benefit is retained by lawyers, investment bankers, lessors and investors, the Federal revenue loss becomes more of a gain to financial entities than to tax-exempt entities. In proportion to that inefficiency, the Treasury loses more than $1 to provide $1 of aid to tax-exempt entities through leasing, whereas the aid could be provided on a dollar-for-dollar basis through appropriations. This problem exists within the Federal government also. To the extent that a Federal agency as lessee pays rents that do not reflect a full pass-through of the lessor's income tax benefits, the Federal government pays more to lease an asset than it would to buy it. The committee received considerable testimony to the effect that Federal leasing procedures are inadequate to prevent this waste.

Fifth, the committee stresses the need to sustain popular confidence that the tax system is generally working correctly. A system which entices Federal agencies not to own their essential equipment, nor colleges their campuses, nor cities their city halls, and which also rewards taxpayers who participate in such transactions with a lighter tax, risks eroding that confidence.

C. Explanation of Provisions

(Secs. 31-33 of the Bill and Secs. 48 and 168 of the Code)

1. Overview

In general, the committee bill reduces the tax benefits that would otherwise be available for tangible property used by tax-exempt entities. The bill defines the term "tax-exempt entity" to include Federal, State, local, and foreign governments, possessions of the United States, international organizations, certain instrumentalities of the foregoing, and certain foreign persons, as well as most organizations that are exempt from Federal income tax or were exempt at any time within a prescribed 5-year period.

The bill also provides criteria for use in determining whether an arrangement characterized by the parties as a "service contract" or carrying some other label should, for purposes of determining whether property is tax-exempt use property (defined below), be treated as a lease to the tax-exempt entity. However, the bill creates no inferences regarding the present-law treatment of purported service contracts under the nontaxable use restriction on the investment credit.

To the extent a rehabilitated building is tax-exempt use property, rehabilitation credits are denied under the bill if the rehabilitation expenditures are, or acquisition of the building to be rehabilitated is, financed in whole or in part with tax-exempt obligations.

Special rules are provided for qualified technological property, property subject to short-term leases, and certain other property.

Present-law rules for determining the owner of property for income tax purposes are unchanged. Thus, the bill leaves open the possibility that a tax-exempt entity could be treated as the owner of property under a purported lease, service contract, or other arrangement. The bill creates no inferences regarding who under present law should be treated as the tax owner of property involved in such a transaction.

2. Definition of Tax-Exempt Entity

Under the bill, the term "tax-exempt entity," for purposes of both the depreciation and investment credit provisions, includes the United States, any State (including the District of Columbia) or local governmental unit, any possession of the United States (including Puerto Rico), and any agency or instrumentality of any of the foregoing (other than any agency or instrumentality of the United States or any State or local governmental unit all the income of which, if any, is fully subject to United States income tax if neither the United States nor any State or political subdivision thereof selects or has the right to select at least a majority of the board of directors or members of a similar governing body of such agency or instrumentality).

The term also includes any organization, other than a farmers' cooperative described in section 521, that is exempt from United States income tax and any organization (and any predecessor organization engaged in substantially similar activities) that was exempt from United States income tax (other than by virtue of section 521) at any time during the 5-year period ending on the date the property involved is first used by such organization. However, it is not intended that the bill treat property owned by any such former tax-exempt organization as tax-exempt use property.

For example, assume that a tax-exempt hospital has historically leased or owned automobiles for use in carrying out its tax-exempt function. On January 15, 1984, the hospital creates a wholly-owned taxable subsidiary to lease new automobiles and provide transportation services to the hospital. Automobiles leased by the subsidiary any time prior to January 15, 1989, will be tax-exempt use property.

In addition, the term includes any foreign government, any international organization, any agency or instrumentality of either of the foregoing, and any other person who is not a United States person. However, the term includes any other person who is not a United States person only with respect to property 50 percent or less of the gross income, if any, derived by the foreign lessee from the use of which is subject to United States income tax for the taxable year of the foreign lessee. In determining whether the 50-percent threshold is satisfied, the portion of the gross income derived by the foreign lessee from the use of the property that is subject to U.S. income tax is to be determined after taking into account all exclusions and exemptions, whether derived from a statute, a treaty, or otherwise, but total gross income from the use of the property is to be determined without regard to any such exclusions or exemptions.

3. Tax-Exempt Use Property

Personal property

For purposes of the depreciation and investment credit provisions of the bill, tangible property which is not 15-year real property will be tax-exempt use property if it is owned by, leased to, or otherwise used by a tax-exempt entity. A special rule applies with respect to certain property held by certain international organizations. Except to the extent modified by the provisions of the bill dealing with service contracts or similar arrangements, the determination of whether personal property is tax-exempt use property is made under present law rules. Thus, for example, if a taxable entity manufactures personal property for purchase by a tax-exempt entity in a normal commercial transaction, which is not an arrangement treated as a lease under the bill, the property used by the manufacturing entity to produce the property sold to the tax-exempt entity is not tax-exempt use property.

Real property

In general

For purposes of the depreciation and investment credit provisions of the bill, 15-year real property will be treated as tax-exempt use property if it is owned by a tax-exempt entity, or to the extent it is used by a tax-exempt entity or entities but only if at least one of the following circumstances exists:

(1) All or a part of the property was financed with the proceeds of tax-exempt obligations and the tax-exempt entity (or a related party) participated in such financing;

(2) The use is pursuant to a lease containing or accompanying (i) a fixed or determinable price purchase option exercisable by the tax-exempt entity (or a related party), (ii) a fixed or determinable price sale option pursuant to which the lessor can require the tax-exempt entity (or a related party) to purchase the property, or (iii) the equivalent of either such option;

(3) The use occurs after a sale, or other disposition or transfer of the property by, or lease of the property from, the tax-exempt entity (or a related party); or

(4) The use is pursuant to a lease with a term exceeding 80 percent of the remaining economic useful life of the property, determined at the time the lease is entered into.

However, in no event will any portion of any 15-year real property be treated as tax-exempt use property unless more than 20 percent of the property is used by a tax-exempt entity or tax-exempt entities in a use or uses of a type or types described above. For purposes of this rule, each building will be treated as a separate property unless two or more buildings are part of one project. In the latter case, the entire project will be treated as one property. Furthermore, uses of the types described above by unrelated tax-exempt entities will be aggregated in determining whether property is tax-exempt use property and the extent thereof, and use by one tax-exempt entity related to another tax-exempt entity will be treated as use by the latter as well as the former. Finally, the extent to which property is tax-exempt use property will be measured by those factors producing the greatest amount of tax-exempt use. For example, assume that a tax-exempt entity sells a building, leasing 50 percent of it back for more than 80 percent of remaining useful life and leasing the other 50 percent back for 10 years. Because the entire building was sold and leased back, the entire building is tax-exempt use property even though only one-half of it was leased to the tax-exempt entity for a term exceeding 80 percent of its remaining useful life. On the other hand, assume that a tax-exempt entity, which leases 50-percent of a building for 5 years, has an option to purchase the entire building at a fixed price. Absent other factors, only 50-percent of the building is tax-exempt use property since the tax-exempt entity is using only 50 percent of the property.

The committee intends that a tax-exempt entity or entities will be treated as using more than 20 percent of a building only if it or they use or are entitled to use more than 20 percent of the net rentable floor space in the building. Net rentable floor space is not to include common areas.

To illustrate the application of the rules for determining whether and to what extent 15-year real property is tax-exempt use property, assume in the examples that follow that a tax-exempt entity participates in industrial development bond financing for the acquisition of a new building by a taxpayer. The tax-exempt entity leases 80 percent of the building for 5 years. Eighty percent of the building is tax-exempt use property under the bill. If the tax-exempt entity leased only 19 percent of the building for 5 years, no portion of the building would be tax-exempt use property. If the tax-exempt entity leased only 19 percent of the building for 5 years and another tax-exempt entity leased 10 percent of the building for a term in excess of 80 percent of the building's remaining useful life (or a related entity leased 10 percent of the building for 5 years), 29 percent of the building would be tax-exempt use property. If the tax-exempt entity leased only 19 percent of the building for 5 years and an unrelated tax-exempt entity leased 10 percent of the building for 5 years, none of the building would be tax-exempt use property. If the tax-exempt entity leased 75 percent of the building for a term exceeding 80 percent of the building's economic life, 75 percent of the building would be tax-exempt use property. This last conclusion would not change even if industrial development bonds had not been used.

A special rule applies with respect to certain property held by certain international organizations.

Participation in tax-exempt financing

Whether a tax-exempt entity (or a related party) will be treated as having participated in financing the acquisition of all or a part of the property through tax-exempt obligations depends on all the circumstances. However, a tax-exempt entity will be treated as having participated if it (or a related tax-exempt entity) issues the obligations and it is reasonable to expect at the time of issuance that the tax-exempt entity will be a user of all or a portion of the property. A tax-exempt entity will also be treated as having participated in the financing if, prior to the financing, it commits to lease space in the building. For example, an organization described in section 501(c)(3) will be treated as having participated in a bond financing if, prior to the issuance of the bonds, it commits to enter into a lease of all or part of the property after it has been acquired by the taxpayer. If a tax-exempt entity finances the acquisition or construction of a building with tax-exempt obligations, sells the new building to the taxpayer before using it, and then leases all or a part of it, the tax-exempt entity will be treated as having participated in the financing.

Purchase or sale options

A fixed or determinable price purchase or sale option exists if the tax-exempt entity (or a related party), directly or indirectly, has a legally enforceable option to buy the property involved from the lessor, or the lessor has a legally enforceable right to "put" the property to the tax-exempt entity (or a related party), at either a pre-established price or at a price that is determinable pursuant to a formula. An option or put at fair market value at the time of exercise will not be treated as a fixed or determinable price option or put. Nor will an option or put be so treated if the selling price is determinable pursuant to a formula which the parties, when agreeing to it, reasonably expected would produce a number approximately equal to fair market value at the time of exercise. An option to purchase in 15 years for an amount equal to 50 percent of original cost will be an option at a fixed or determinable price. However, an option to purchase at a price derived by a formula which incorporates rents then paid by taxable entities for the use of the same or similar property and then-prevailing interest rates will not be an option at a fixed or determinable price, so long as the parties, when they agreed to the formula, reasonably expected it to produce a number approximately equal to fair market value at the time of exercise.

Furthermore, any provision which has the effect of passing on to the lessee or a related party the risk that the property's residual value will decrease will be treated as the equivalent of a fixed or determinable price put. For example, assume that a tax-exempt entity leases land to a taxable entity for 20 years. The taxable entity constructs a building, which has an economic useful life of 50 years, on the land and leases it to the tax-exempt entity for the balance of the term of the ground lease. Because the tax-exempt entity has dominion over the building for its entire economic useful life, the tax-exempt entity may be treated as its tax owner under present law. However, if the tax-exempt entity is not treated as the owner, the property would be tax-exempt use property in any event because the tax-exempt entity has the equivalent of a fixed price purchase or sale option. Similarly, assume that a lease provides that if the lessee cancels or fails to renew the lease or if the property involved is destroyed, the lessee will pay or cause to be paid to the lessor the difference between the amount necessary to preserve the lessor's net economic return and the fair market value of the property. The lease is treated as containing the equivalent of a determinable price sale option.

An option need not be contained in the lease. It may be a separate agreement. An option to buy or put stock in a corporation (or equity interests in any other entity) which owns the property may be treated as an option to buy or put the property.

Uses after transfers

The use by a tax-exempt entity after a disposition or other transfer of the property by the entity (or a related party) includes all forms of transactions in which a tax-exempt entity (or a related party), directly or indirectly, sells, leases, disposes of, or otherwise transfers property theretofore owned by it and subsequently uses it. For example, if a tax-exempt entity contributes a building to a partnership and leases back a portion of the building, the transaction will be treated as a sale-leaseback for purposes of the bill. As a further example, if property is owned by a corporation that is owned by a tax-exempt entity, a sale or other disposition of the stock of that corporation will be treated as a sale or other disposition of the property. Finally, property owned by a tax-exempt entity (or a related party) which is subsequently leased to the tax-exempt entity pursuant to one overall arrangement will be tax-exempt use property regardless of from whom the lessor obtained the property. For example, assume a tax-exempt entity sells a building to a taxable entity. The taxable entity sells or contributes the building to a partnership which, pursuant to one overall plan, leases it to the tax-exempt entity. The building is tax-exempt use property.

If a tax-exempt entity disposes of its ownership interest in a property before that property is placed in service by the tax-exempt entity (or a related party), the tax-exempt entity will not be treated as having transferred the property. For example, assume that a tax-exempt entity contracts to have a building constructed. Before the building is substantially completed, the tax-exempt entity assigns the construction contract to a taxpayer and agrees to lease the building from the taxpayer upon its completion. The property will not be treated as having been sold and leased back.

Lease term

For purposes of determining whether a lease has a term in excess of 80 percent of a building's remaining useful life at the time the lease is entered into, the building's then remaining useful life will be determined under the particular facts and circumstances. For other rules relating to the lease term, see the discussion below.

Improvements

The bill provides that improvements to property (other than land) will not be treated as separate property, but only for purposes of determining whether there is tax-exempt use of property not owned by a tax-exempt entity. For example, if a governmental unit issues tax-exempt obligations, the proceeds of such issue are used by a taxpayer to acquire a building shell from a third party, and the taxpayer improves the building shell using other funds and leases the improved building to the governmental unit, the governmental unit will be treated as having participated in the tax-exempt financing of the entire property. Similarly, if a tax-exempt entity sells a building shell to a taxpayer and the taxpayer rehabilitates the building shell and leases the rehabilitated building back to the tax-exempt entity, the tax-exempt entity will be treated as using one property after a sale-leaseback.

On the other hand, if unimproved land is disposed of by a tax-exempt entity, a building is constructed on the land by the new owner, and the improved land is leased to the tax-exempt entity, the building will not be treated as having been the subject of a sale-leaseback.

Tax-exempt use property does not include improvements constructed by a taxable entity on underlying land or other property leased from a tax-exempt entity merely because the tax-exempt entity is the owner of the land or other property. For example, assume that a tax-exempt university leases land to a taxable entity for 45 years. The taxable entity constructs a building, which has an economic useful life of 40 years, on the land and leases it to a third-party taxpayer (or the university) for 30 years since the lease term does not exceed 80 percent of the property's useful life. The building is not tax-exempt use property. Similarly, assume that a municipality leases a certified historic structure to a taxable entity for 20 years. The taxable entity rehabilitates the structure in one year, using industrial revenue bonds, in a rehabilitation qualifying under section 48(g), converting it into a shopping mall. The rehabilitated mall is leased, piece-by-piece, to a variety of taxable merchants. No leasehold improvement is tax-exempt use property. However, the municipality is the tax owner of the building shell.

Other rules

A determination that there is a tax-exempt use of property does not require that the ultimate user of the property be a tax-exempt entity. A disqualified use at any point in a chain of use subjects the property to the bill. A similar rule applies with respect to the nontaxable use restriction of present law. For example, assume that a corporation constructs a new convention center and leases it to a city under an arrangement in which the city has a fixed price option to buy after 20 years. The city subleases or licenses the property to a variety of taxable entities that use it. The entire structure is tax-exempt use property.

Similarly, if a U.S. corporation leases equipment (e.g., a drilling rig) to a foreign corporation not subject to U.S. tax and the foreign corporation subleases the equipment to a branch of a U.S. corporation, the property is tax-exempt use property even though all income earned by the U.S. branch with respect to the use of the property is subject to U.S. tax. (This result would not occur if, in view of the economic substance of the arrangement, the lease to and sublease by the foreign corporation was disregarded for U.S. tax purposes.) This result occurs without regard to the business reasons for the initial lease between the U.S. corporation and the foreign corporation.

Nor can a tax-exempt entity avoid the provisions of the bill merely by being a sublessee. Thus, if corporation A leases property to corporation B under a lease with a fixed price option and corporation B subleases the property to a tax-exempt entity, assigning its fixed price option to the tax-exempt entity, the property will be tax-exempt use property.

Whether the tax-exempt entity is the tax owner of the property will be determined under present law. For example, a tax-exempt entity may hold legal title to property, used by a taxable entity, as a security device in connection with an industrial revenue bond. If the tax-exempt entity is not the tax owner of the property, the mere fact that it has legal title will not cause the property to be treated as tax-exempt use property. *See* Rev. Rul. 68-590, 1968-2 C.B. 66.

Tax-exempt use property does not include any property or portion thereof predominantly used by a tax-exempt entity in an unrelated trade or business the income of which is subject to tax under section 511.

4. Depreciation

General recovery period and method

In the case of tax-exempt use property, accelerated cost recovery deductions and any other deductions for depreciation or amortization are to be computed by using the straight-line method and disregarding salvage value. The recovery period for tax-exempt use property in the 15-year real property class is 40 years or 125 percent of the term of the lease, whichever is greater. The recovery period for all other tax-exempt use property is the mid-point life of the property as of January 1, 1981, under the ADR system, or 100 percent of the term of the lease, whichever is greater. Personal property that has no ADR life will be treated as having a mid-point life of 12 years. Property treated as leased to a tax-exempt entity under the bill's provisions for distinguishing service contracts and other arrangements from leases (see below) will be treated as leased to the tax-exempt entity for purposes of the bill's depreciation provisions.

Qualified technological equipment

The general depreciation provisions of the bill do not apply to "qualified technological equipment" (defined below) used by a tax-exempt entity pursuant to a lease with a term of 5 years or less. Except as indicated below, the cost (disregarding salvage value) of qualified technological equipment used by a tax-exempt entity pursuant to a lease with a term of more than 5 years is to be recovered using the straight-line method, a 5-year recovery period, and the half-year convention. Present law is retained for qualified technological equipment to which section 168(f)(2) (relating to recovery property used predominantly outside the United States) applies.

As with other property, whether qualified technological equipment purportedly leased to a tax-exempt entity is to be treated as owned for tax purposes by the tax-exempt entity will be determined under present law. For example, if qualified technological equipment with an economic useful life of 5 years is purportedly leased for 5 years, the nominal lessee may be treated as the tax owner of the equipment.

For purposes of the bill, qualified technological equipment consists only of computers and related peripheral equipment, high technology telephone station equipment installed on a customer's premises, and high technology medical equipment. Only tangible personal property can constitute qualified technological equipment.

Computers are programmable electronically activated devices capable of accepting information, applying prescribed processes to it, and supplying the results of those processes with or without human intervention. Computers consist of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities. The term related peripheral equipment means auxiliary machines (whether on-line or off-line) designed to be placed under the control of the central processing unit of the computer. Neither term includes any equipment which is an integral part of property which is not a programmable computer, any video games or other devices used by the user primarily for amusement or entertainment purposes, or any typewriters, calculators, adding or accounting machines, copiers, duplicating equipment, or similar equipment.

High technology telephone station equipment includes only property described in ADR class 48.13 and installed on a customer's premises. Furthermore, property described in ADR class 48.13 which does not have a high technology content does not qualify.

The term "high technology medical equipment" means any electronic, electromechnical, or computer-based high technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of human patients in a laboratory, medical, or hospital environment. High technology medical equipment can include C.A.T. scanners, nuclear magnetic resonance equipment, clinical chemistry analyzers, drug monitors, diagnostic ultrasound scanners, nuclear cameras, radiographic and fluoroscopic systems, Holter monitors, and bedside monitors. Incidental use of any such equipment for other purposes, e.g., research, will not prevent it from qualifying as high technology hospital equipment.

For purposes of the rules regarding high technology telephone station equipment and high technology medical equipment, high technology equipment consists only of equipment which, because of a high technology content, can reasonably be expected to become obsolete before the expiration of its physical useful life. For example, telephone booths and telephones which include only a standard dialing feature are not high technology equipment. However, telephones which include features such as an abbreviated dialing short program, an automatic callback, or conference call feature qualify as high technology equipment. The exception applies only to terminal equipment that contains such extra features and not to terminal equipment used in conjunction with features offered through central office capacity.

Qualified technological equipment does not include equipment which (1) is used by a tax-exempt entity after its disposition by the same tax-exempt entity (or a related party) if the tax-exempt entity (or a related party) used it before the disposition, (2) is financed with tax-exempt obligations, or (3) is used by the Federal government or a tax-exempt instrumentality thereof. Such equipment will be subject to the bill's general depreciation provisions.

The committee bill directs the Secretary of the Treasury to study whether the January 1, 1981, ADR mid-point lives for qualified technological equipment are inappropriate and to report the conclusions to Congress not later than July 1, 1984. The bill also grants Treasury authority to develop mid-point lives for any property that currently has no ADR life.

Operating rules

If a taxpayer elects under ACRS to recover the cost of property over an optional recovery period that exceeds the recovery period prescribed by the bill, then the cost of the property is to be recovered over the longer period. Property which would be 15-year real property if it were recovery property is treated as 15-year real property for purposes of the bill. For 15-year real property, first-year deductions are to be determined on the basis of the number of months in the year in which the property is in service. For other property, the half-year convention used under present law applies. For example, if the recovery period under the bill is 10 years, the cost recovery percentage will be 5 percent for the taxable year the property is placed in service by the taxpayer, 10 percent for each of the next 9 taxable years, and 5 percent for the eleventh taxable year.

Section 168(f)(12) of present law (relating to depreciation of certain property financed with industrial development bonds) is not to apply to tax-exempt use property subject to one of the depreciation provisions of the bill.

The committee intends that regulations be promulgated under section 168(f)(13) (relating to changes in use of depreciable property) of present law to apply to property the tax ownership of which has not changed which either becomes or ceases to be tax-exempt use property some time after having been placed in service by the taxpayer.

5. Investment Tax Credit

As under present law, the investment credit (including the investment credit for energy property) generally will be denied for property (including qualified technological equipment) leased to or otherwise used by tax-exempt entities. The bill expands the category of tax-exempt entities subject to the nontaxable use restriction and provides statutory guidelines for distinguishing a service contract or other arrangement from a lease (see below). Property which becomes tax-exempt use property some time after having been placed in service will cease to be section 38 property at the time it becomes tax-exempt use property with the result that all or part of the investment credit may be recaptured. The present-law exception to the nontaxable use restriction for short-term or casual leases is retained for purposes of the investment tax credit. A special rule applies with respect to certain property held by certain international organizations.

Expenditures attributable to the rehabilitation of any portion of a building that is tax-exempt use property will not qualify for the rehabilitation credit if the expenditures are, or the cost of acquiring the building or any interest therein is, financed in whole or in part with the proceeds of tax-exempt obligations. However, the excluded expenditures will be taken into account under section 48(g)(1)(C) in determining whether there has been a substantial rehabilitation of the building. If rehabilitation expenditures are, or the cost of acquiring the building is, financed in whole or in part with the proceeds of tax-exempt obligations and all or a portion of the building becomes tax-exempt use property for the first time within 5 years, rehabilitation credits will be recaptured at that time as if that portion of the building which becomes tax-exempt use property had then been disposed of.

For example, assume that a taxpayer finances the $25,000 acquisition cost of a building with tax-exempt obligations. The taxpayer then spends $30,000 of its own money rehabilitating the building. One-third of the rehabilitated building is then leased to a tax-exempt entity under circumstances which make the one-third tax-exempt use property. No rehabilitation credit will be allowed on the $10,000 in rehabilitation expenditures attributable to that part of the building which is tax-exempt use property. However, a rehabilitation credit will be allowed on the other $20,000 in rehabilitation expenditures. If the other two-thirds of the building becomes tax-exempt use property within 5 years after the rehabilitation is completed, rehabilitation credits on the $20,000 will be recaptured.

6. Property Used Under Certain Service Contracts

The committee bill provides for the treatment of property used under a purported service contract arrangement with a tax-exempt entity as used by the tax-exempt entity if the arrangement is more properly characterized as a lease. That provision of the bill applies to contracts under which property is used to provide services to or for the benefit of a tax-exempt entity. The bill creates no inferences regarding the treatment of service contracts under present law. Nor does the bill affect the present-law rules for determining the treatment of management contracts under which a tax-exempt entity performs services with respect to property owned by a taxpayer.

The service contract provisions apply for purposes of the depreciation provisions of the bill and for purposes of the nontaxable use restriction on the investment credit (as modified by the bill). This provision applies to service contracts involving personal property or real property, whether the so-called service provider is the tax owner or the lessee of the property.

Factors to be considered

In determining whether a transaction structured as a service contract is more properly treated as a lease, the committee bill requires that all relevant factors be taken into account, including, but not limited to, whether (1) the tax-exempt entity is in physical possession of the property, (2) the tax-exempt entity controls the property, (3) the tax-exempt entity has a significant possessory or economic interest in the property, (4) the service provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (5) the service provider uses the property concurrently to provide services to other entities unrelated to the tax-exempt entity, and (6) the total contract price substantially exceeds the rental value of the property for the contract period.

Physical possession

Physical possession of property is indicative of a lease. Under the bill, property that is located on the premises of a tax-exempt entity, or located off the premises but operated by employees of a tax-exempt entity, is viewed as in the physical possession of the entity. However, property is not in the physical possession of a tax-exempt entity merely because the property is located on land leased to the service provider by the tax-exempt entity.

Control of the property

The fact that the tax-exempt entity controls the property is indicative of a lease. Under the bill, a tax-exempt entity is viewed as controlling the property to the extent the entity dictates or has a contractual right to dictate the manner in which the property is operated, maintained, or improved. Control is not established merely by reason of contractual provisions designed to enable the tax-exempt entity to monitor or ensure the service provider's compliance with performance, safety, pollution control, or other general standards.

Possessory or economic interest

A contract that conveys a significant possessory or economic interest to a tax-exempt entity resembles a lease. Under the bill, the existence of a possessory or economic interest in property is established by facts that show (1) the property's use is likely to be dedicated to the tax-exempt entity for a substantial portion of the useful life of the property, (2) the tax-exempt entity shares the risk that the property will decline in value, (3) the tax-exempt entity shares in any appreciation in the value of the property, (4) the tax-exempt entity shares in savings in the property's operating costs, or (5) the tax-exempt entity bears the risk of damage to or loss of the property.

Substantial risk of nonperformance

Under a service contract arrangement, the service provider bears the risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract by the service provider or any property involved. Under the bill, facts that establish that the service provider does not bear any significant risk of nonperformance are indicative of a lease.

Concurrent use of property

The concurrent use of the property to provide significant services to entities unrelated to the tax-exempt entity is indicative of a service contract.

Rental value of property relative to total contract price

The fact that the total contract price (including expenses to be reimbursed by the tax-exempt entity) substantially exceeds the rental value of the property for the contract period is indicative of a service contract. If the total contract price reflects substantial costs that are attributable to items other than the use of the property subject to the contract, then the contract more closely resembles a service contract. Conversely, the fact that the total contract price is based principally on recovery of the cost of the property is indicative of a lease. A contract that states charges for services separately from charges for use of property is indicative of a lease.

Other rules

A contract will be treated as a lease rather than a service contract if the contract more nearly resembles a lease. Although each of the factors in the bill must be considered, a particular factor or factors may be insignificant in the context of any given case. Similarly, because the test for determining whether a service contract should be treated as a lease is inherently factual, the presence or absence of any single factor may not be dispositive in every case. For example, even if a tax-exempt entity does not have physical possession of property, the arrangement could still be treated as a lease after taking all other relevant factors into account.

Examples

The following examples illustrate the application of the service contract provisions of the committee bill. In each of these examples, T is a taxpayer and E is a tax-exempt entity.

Example (1)

E, an agency of the Federal government, desires to obtain the use of a built-to-purpose vessel. A contractor arranges for the construction of the vessel and for the sale of the vessel to T. The contractor then leases the vessel from T, the shipowner, under a long-term bareboat charter. E and the contractor enter into a time charter with respect to the vessel. The time charter provides for the transportation of equipment, cargo, and personnel. Under the time charter, E has the right to designate the port of call and the cargo to be carried. The master, officers, and crew of the vessel are hired by the contractor, subject to E's approval. All officers of the vessel must qualify for a government "confidential" security clearance. In addition, the master, chief officer, and radio officer must qualify for a government "secret" security clearance. E reserves the right to station 28 permanent government personnel aboard the vessel and to assign up to 100 additional military personnel to the vessel. However, the master of the vessel is under the direction of the contractor as regards navigation and care of the cargo. E also has the right to cause alterations to be made to the vessel. E must make separate payments for "Capital Hire" (computed by reference to the amount required to repay, with interest or a guaranteed return, the debt financing and equity investment of T) and "Operating Hire" (which covers the cost of operating the vessel and the contractor's profit). Payments of Operating Hire are suspended or reduced when the vessel is not fully available for service. However, E must continue to pay Capital Hire during such period.

The time charter has an initial term of 5 years. E has the option to extend on similar terms the basic term for one to four successive renewal periods, for a total of 25 years. The useful life of the vessel is in excess of 30 years. E can terminate the time charter for convenience at any time during the renewal periods. Upon a termination for convenience or if E fails to exercise a renewal option, E is required to pay any difference between the proceeds of the sale of the vessel and the "Termination Value" set forth in the time charter. The "Termination Value" is an amount approximating T's unrecovered equity, remaining debt service, and tax liability generated by the vessel's sale. E has the option to purchase the vessel at any time after the end of the basic 5-year term for the greater of fair market value or Termination Value at the time of purchase. If E purchases the vessel, E can require that the contractor continue to operate the vessel under the same terms as set forth in the time charter. If the vessel is damaged, destroyed, or otherwise lost due to causes beyond the contractor's control, E must pay any difference between Termination Value and any insurance proceeds. Thus, E also bears the risk of damage to or loss of the vessel.

E may be considered the owner of the vessel under the general principles for determining ownership for Federal income tax purposes. If, however, T were considered the owner, under the bill E would be treated as having a leasehold interest in the property (and the vessel would be tax-exempt use property). In the latter case, the following facts would serve as the basis for the conclusion that E is treated as having a leasehold interest: (a) E has some control over the vessel in that E can direct that alterations be made, (b) E has a significant possessory interest because the time charter contemplates that the vessel's use will be dedicated to E for a substantial portion of its useful life, the requirement that Termination Value be paid shifts the risk that the vessel will decline in value to E, and E bears the risk of damage to or loss of the vessel, (c) T does not bear a substantial risk of nonperformance within the meaning of the bill, because payments of Capital Hire continue even if the vessel is unavailable for service, (d) regarding the rental value of the property relative to the total contract price, the test for a service contract is not satisfied since the Capital Hire represents payments for the cost of the vessel and the Operating Hire represents separate payments for services, and (e) all other relevant facts and circumstances, including the facts that the vessel was built-to-purpose and the terms of E's purchase option. The facts that the contractor (and not E) has physical possession of the vessel and that there is no concurrent use of the vessel to provide services to other persons are insignificant in the context of this case.

Example (2)

The facts are the same as in example (1) except that (a) E has no right to make alterations to the vessel, (b) E's obligation to pay charter hire is set at a rate per deadweight ton and is subject to the condition that the vessel be in full working order, (c) the time charter has an initial term of 5 years, with an option to renew for one to five one-year periods, for a total of 10 years, (d) T bears the risk of damage to or loss of the vessel, and (e) E has no option to purchase the vessel. In addition, E is not required to pay Termination Value (or any other penalty) if it fails to exercise a renewal option.

On these facts, the time charter will be respected as a service contract under the bill (and the vessel will not be tax-exempt use property). The following facts provide the basis for that conclusion: (a) E has no control over the vessel, (b) E has no possessory or economic interest in the vessel, (c) the contractor bears a substantial risk of nonperformance, since the contractor will receive no revenues if the vessel is unavailable for service, and (d) the facts do not indicate that any portion of the charter hire is based on the cost of the vessel.

Example (3)

E, a municipal housing authority, owns Section-8-assisted low-income housing projects. E sells the property to T, a partnership of taxable persons. In order to ensure that the purposes of the Section-8 housing program are fulfilled, T retains E to manage the property under a long-term management contract. Under the management contract, E performs many of the same managerial and administrative functions that it performed before the sale. However, T exercises a degree of control over E's activities, by virtue of provisions in the management contract that require E to keep adequate records of its operations, to use its best efforts to lease the housing units, and to pay net earnings to T within a reasonable time period. For these services, E is compensated by a fee determined on an arm's-length basis. T bears the risk that the property will decline in value and that the property will be damaged or lost. E does not have an option to repurchase the property.

The mere fact that E continues to control the maintenance and operation of the property under a management contract does not provide a basis for treating the contract as a lease under the service contract provision of the bill. However, the bill leaves open the possibility that an arrangement structured as a management contract could be treated as a lease (under which the tax-exempt entity provides services to third parties for its own benefit) under present law rules. *See McNabb* v. *Commissioner*, 81-1 USTC 9143 (W.D. Wash. 1980) (where an arrangement structured as a management contract was characterized as a lease because the taxpayer did not adequately control the venture and did not bear the risk of loss); *Meagher* v. *Commissioner*, 36 T.C.M. 1091 (1977) (where the court held that an agreement was a management contract and not a lease, applying the same tests discussed in the *McNabb* case).

Example (4)

E, a municipal agency, acquires an industrial park and then leases the facility to T, a taxable person, for a term in excess of 15 years. T substantially rehabilitates the building, and then subleases the improved property to other taxable persons. T retains E to manage the property under a management contract.

T owns the improved portion of the building. The mere fact that E performs services with respect to the entire property under a management contract does not provide a basis for treating the improvements as tax-exempt use property under the service contract provision of the bill. Rather, the status of the management contract, as it relates to the leasehold improvements, is determined under present-law rules.

Example (5)

E, a municipality, and T, a private company, enter into a long-term agreement under which E will be the primary but not the only customer of a local district heating system (the System) that will be constructed, owned, operated, and maintained by T. A local district heating system consists of a pipeline or network which includes or is connected to a central heating source (such as a cogeneration facility or a solid waste resource recovery facility) that furnishes energy for heating through hot water or steam to two or more users for residential, commercial, or industrial heating or processing of steam. The System requires periodic maintenance and repair. The agreement between E and T provides for the distribution of BTUs to buildings owned by E. 40 to 75 percent of T's investment in the System will be allocable to the cost of pipeline, and the balance will be allocable to the cost of building or retrofitting a heating source. Approximately 97 percent of the pipeline included in the System is located off of E's premises. The only part of the System located on E's premises are pipes (for delivering the energy), meters (to measure E's usage), and heat exchangers. The in-building investment (attributable to pipes, meters, and heat-exchangers) may, in the case of some of the buildings owned by E, be made by E. In many cases, the only in-building investment made by T will be the cost of a meter. E will make monthly payments to T, determined by the amount of energy E consumes. T will also use much of the System to distribute BTUs to buildings owned by taxable persons in T's service area, under similar contracts.

On these facts, the agreement between E and T will not be treated as a lease. The following facts provide the basis for that conclusion: (a) E has physical possession of, at most, only a nominal part of the System, (b) E does not control the System, (c) T bears a substantial risk of nonperformance in that T will derive revenue from E based solely on the amount of energy E consumes, (d) T concurrently uses the System to provide energy to others, and (e) the System requires significant servicing by T. The fact that E has an economic or possessory interest in the property is, under the circumstances, outweighed by the other factors.

Example (6)

T, a private company, and E, a Federal governmental agency, enter into a contract under which T will construct and operate a solar energy system (the System). The System will be owned by a group of private investors. The System will be constructed on the roof of a building owned by E. All of the hot water and steam produced by the System will be sold to E under a long-term contract. E must pay a significant penalty if it defaults on the contract. However, T will receive no revenues under the contract unless the System produces energy. T is solely responsible for the operation and maintenance of the Facility. However, because the Facility is substantially maintenance free, the total contract price exceeds the rental value of the Facility by only 5 to 10 percent.

On these facts, the agreement between E and T is treated as a lease (and the System is tax-exempt use property) under the bill. That conclusion is based on the following facts: (a) E has physical possession of the System, (b) E has a possessory or economic interest in the System as the use of the property will be dedicated to E for the property's entire economic life, (c) there is no concurrent use of the property, and (d) the total contract price exceeds the rental value of the property by an insignificant amount. The facts that T controls the property and bears a risk of substantially diminished receipts do not provide a basis for a contrary conclusion because they have little meaning under the circumstances

Special rules for qualified solid waste disposal facilities

The bill provides special rules for service contract arrangements involving qualified solid waste disposal facilities. A qualified solid waste disposal facility will be exempt from the depreciation provisions of the bill and the nontaxable use restriction on the investment credit. However, the special rules for service contracts involving qualified solid waste disposal facilities create no inferences regarding the treatment of property subject to the general service contract provisions.

The term "qualified solid waste disposal facility" is defined as any facility that (1) provides solid waste disposal services for residents of part or all of one or more governmental units, if substantially all of the solid waste processed at such facility is collected from the general public, (2) generates marketable quantities of steam, hot water, or electricity, whether or not marketed, (3) is not controlled by or in the physical possession of a tax-exempt entity, and (4) with respect to which the service provider bears a risk of substantially diminished receipts or increased expenditures if there is nonperformance under the contract. For purposes of this rule, the general public includes commercial and other businesses, but only if the waste collected from such businesses is collected from them in their capacities as members of the general public (and not as members of a limited group such as a group that generates waste not processable by normal waste facilities serving the public).

Example (7)

E, a municipality, and T, a private company, enter into a solid waste disposal agreement under which T will construct, own, and operate a solid waste resource recovery facility (the Facility) on land leased from E. The Facility will process solid waste (of the type that is currently collected and disposed of as a part of normal municipal collections), generate steam, convert the steam to electricity, and recover ferrous metals from residual ash. T will invest 25 percent of the construction costs, and the balance will be financed with the proceeds of an issue of tax-exempt industrial development bonds to be issued by E. T will construct the project over a 3-year period and operate it for 20 years. Pursuant to a related energy purchase agreement, U, a utility unrelated to E, will be required to purchase a minimum amount of steam during each year of the same 20-year period. Absent default by T, E will pay an annual fee based on the greater of 400,000 tons of solid waste, regardless of whether such amount is actually delivered, or the number of tons of solid waste actually delivered. The fee is subject to a downward adjustment to reflect increases in T's energy revenues. T bears the primary risks of cost overruns, construction delays, and the possibility that the Facility will be unable to process the amount of waste or generate the amount of steam expected by the parties. Should the Facility be unavailable for service, T will be required to incur the expense of burying the solid waste delivered by E at a land fill site, at no extra charge to E.

E can terminate the agreement on performance grounds. In that event, E might obtain possession of the Facility until a new operator is found. In addition, E's employees may enter the Facility at any time to monitor and ensure T's compliance with contractual performance standards and environmental protection laws and regulations.

The Facility qualifies for the special service contract rule because (a) the solid waste disposed of is collected from the general public, (b) the Facility produces significant amounts of steam and electricity, (c) E is not viewed as controlling the property, notwithstanding the ability of E's employees to ensure that T complies with general performance and regulatory standards, (d) E is not in physical possession of the property, notwithstanding the contractual provision that would entitle E to possession until a new operator is found, and (e) T bears a substantial risk of nonperformance because of T's obligation to dispose of the waste delivered by E if the Facility is not operational and because T will lose revenue if the Facility fails to perform.

Treatment of partnerships and other pass-through entities and other arrangements

The committee is concerned that taxpayers and tax-exempt entities may attempt to structure transactions to avoid the restrictions of the bill. Transactions of this character might include the use of partnerships or other pass-through entities. To deal with those transactions, the bill contains two anti-abuse provisions.

First, where property is held by a partnership of which a tax-exempt entity is a member, and where the allocation to the tax-exempt entity is not a qualified allocation, such entity's proportionate share of the property is to be treated as tax-exempt use property. Solely for purposes of this rule, if a tax-exempt entity which has an unrelated trade or business is a partner, and if its share of income or loss of the partnership would be treated as income or loss from an unrelated trade or business, then it will not be treated as a tax-exempt entity.

A qualified allocation is an allocation under which (1) the tax-exempt entity is allocated the same distributive share of each item of partnership income, gain, loss, deduction, credit, and basis (excluding allocations with respect to contributed property), (2) under the partnership agreement, such share remains the same during the entire period that the entity is a partner, and (3) such allocation has a substantial economic effect, as defined under the rules applicable to partnership allocations generally (sec. 704(b)(2)). A tax-exempt entity's proportionate share of property is such entity's share of partnership distributions or items of income or gain (excluding certain built-in gain with respect to contributed property), whichever results in the largest proportionate share. If a tax-exempt entity's share may vary during the period such entity is a partner, the entity's proportionate share is the highest share the entity may receive under the partnership agreement. The application of these rules is not to result in more than 100 percent of any partnership property being treated as tax-exempt use property. The bill provides for the application of similar rules to other pass-through entities (such as a trust).

The committee bill does not affect the present-law rule for determining the tax status of property that is co-owned by a tax-exempt entity under an arrangement that is not classified as a partnership for Federal tax purposes. Thus, a tax-exempt entity will continue to be viewed as owning a separate undivided interest in property held by a joint venture that is classified as a co-tenancy under Federal tax law. *See* Rev. Rul. 78-268, 1978-2 C.B. 10 (which addresses this issue in the context of applying the present law nontaxable use restriction on the investment credit).

Second, the committee bill provides that an arrangement other than a service contract (including but not limited to a partnership or other pass-through entity) with a tax-exempt entity (or a related party) that purports not to be a lease is to be treated as a lease if such arrangement is more properly treated as a lease. In determining whether any given arrangement is more properly treated as a lease, all relevant factors are taken into account, including factors similar to those set forth in the general service contract provisions. This provision is applicable to any arrangement, other than a service contract, under which a tax-exempt entity directly or indirectly obtains the use or benefits of property.

Example (8)

E, a not-for-profit hospital, and T, a partnership composed of individuals who are active members of E's medical staff, enter into a joint venture to acquire and operate a computer axial tomography (or "C.A.T.") scanner. The C.A.T. scanner will be used solely to aid in the diagnosis of diseases of E's patients. Each joint venturer will contribute equal amounts of debt and cash towards the purchase price of the property, and will share equally in net profits and losses and net cash flows, and other partnership items. It is assumed that these allocations have substantial economic effect.. The C.A.T. scanner, which will be located on the premises of E, will be operated by members of T. The day-to-day business of the joint venture will be managed by a representative of each joint venturer. Under the joint venture agreement, T will be responsible for the billing of all technical charges and will receive two percent of gross charges for costs associated with preparing, mailing, and collecting charges. E will bill the joint venture and be reimbursed for occupancy costs (including utilities, housekeeping services, building depreciation, and interest) relating to the location of the C.A.T. scanner on its premises. The joint venturers will be separately responsible for interest, taxes, and insurance relating to participation in the joint venture. However, as between E and T, E is ultimately liable for the debt service obligations with respect to the entire property. The joint venture will terminate at the end of seven years. The useful life of the C.A.T. scanner is approximately nine years. Within six months of termination, T can require that E purchase T's interest in the joint venture at fair market value, adjusted upward if fair market value is less than a price specified in the contract (which price is computed by reference to the amount required to repay T's equity investment with a guaranteed return, less the net profits received by T during the term of the joint venture).

Assuming that the joint venture is properly classified as a partnership rather than a co-tenancy for Federal tax purposes, there is, absent other factors, a qualified allocation. Accordingly, none of the property is tax-exempt use property under the first of the two anti-abuse provisions.

However, the joint venture agreement is also subject to the provision of the bill relating to arrangements other than service contracts that purport not to be leases. The property, by being used for E's patients, is being used for the benefit of E. Nor is it being used in an unrelated trade or business. Under the bill, taking into account factors similar to those enumerated in the general service contract provision, the arrangement is treated as conveying to E a leasehold interest in T's interest in the property. Thus, it is tax-exempt use property under the second anti-abuse provision. The following facts provide the basis for this conclusion: (a) although no payments are required to be made by E to T, T will be compensated through payments made by E's patients and by the terms of the put, (b) E has control of T's interest in the property because E has an equal voice in the operation and maintenance of the entire property, (c) E has a possessory interest in T's interest because the property will be used under the agreement for a substantial portion of the property's useful life and E bears the risk that the property will decline in value by virtue of the put held by T, (d) T does not have the right to use the property to provide services to anyone other than a patient of E, and (e) all other relevant facts, including the facts that the use of the property is integrally related to E's tax-exempt function, that E has guaranteed the repayment of the total acquisition indebtedness, and that the property will be operated only by E's employees. Given the totality of the facts and circumstances, the fact that T bears a risk of substantially diminished receipts is mitigated by E's obligation to fulfill T's debt service requirements and does not provide a basis for a contrary conclusion.

Because the C.A.T. scanner qualifies for the exemption for qualified technological equipment, the cost of T's interest is recovered over 5 years. However, the C.A.T. scanner is ineligible for the investment credit.

7. Short-Term Lease Exception

Property subject to a short-term lease to a tax-exempt entity will not be treated as tax-exempt use property under the depreciation provisions of the bill. For purposes of this rule, the term of a lease begins when property is first used under it. In the case of property other than 15-year real property, a lease of less than 1 year or 30 percent of the property's ADR mid-point life (but not greater than 3 years), whichever is greater, will qualify as a short-term lease. In applying the bill's depreciation provisions with respect to 15-year real property, a lease of less than 3 years will qualify as a short-term lease. In determining whether any portion of a rehabilitated building is tax-exempt use property, for purposes of computing qualified rehabilitation expenditures, a lease of less than 1 year will qualify as a short-term lease. For example, assume that all of a qualified rehabilitated building financed with tax-exempt obligations is leased for 2 years to a tax-exempt entity that participated in the financing. No rehabilitation credit will be allowed, but the depreciation provisions of the bill will not be applicable.

8. Lease Term

For all purposes of the bill, the term of a lease includes all periods for which the tax-exempt lessee (or a related party) has a legally enforceable option to renew, or the lessor has a legally enforceable option to compel renewal by the tax-exempt entity (or a related party), whether the lease is in fact renewed and regardless of the terms at which the lease is renewable. The bill leaves open the possibility that the term of a subsequent lease could be included in the term of the original lease if the circumstances indicate that the parties, upon executing the original lease, had informally agreed that there would be an extension of the original lease. An extension at a rental rate differing materially from the market rental rate at the time of the extension would suggest that the parties had such an informal agreement. Similarly, the committee intends that rules similar to those applied under section 46(e)(3) (relating to investment credits for non-corporate lessors) be applied in determining the term of a lease. See, *e.g., Hokanson v. Commissioner,* 84-1 USTC ¶9217 (9th Cir. 1984), which applies a reasonable expectations test. Also, the bill measures the lease term by counting successive leases as one lease. This rule applies if the original lease and one or more successive leases are entered into comtemporaneously. The successive lease rule will not apply merely because the parties enter into a new lease at fair rental value at the end of the primary lease term.

9. Certain International Organizations

Property owned or used by the International Telecommunications Satellite Consortium or the International Maritime Satellite Organization, or any successor of either, is not tax-exempt use property to the extent of the share of such property of any taxable domestic corporation which is a member of such organization. Such member's share is 100 minus the sum of the proportionate share of each member which is a tax-exempt entity, determined under section 168(j)(8). Furthermore, to the extent such property is not tax-exempt use property, it may qualify as section 38 property.

10. Definition of Related Party

The following related party rules apply under the bill:

Each governmental unit and each agency or instrumentality of a governmental unit is related to each other such unit, agency, or instrumentality the rights, powers, and duties of which derive in whole or in part, directly or indirectly, from the same sovereign authority. Therefore, a multi-State commission is related to each of its member States, since the commission will be deriving its authority from those States. For purposes of this rule, the United States, each State (including the District of Columbia), each possession of the United States (including Puerto Rico), and each foreign country is a separate sovereign authority. Therefore, a city in one State will not be related to a city in another State under the rule. However, each city in a foreign country will be treated as related to every other governmental unit, agency, or instrumentality in that foreign country.

Any entity (other than a governmental unit or an agency or instrumentality of such a unit) is related to any other person if the two have (a) significant common purposes and substantial common membership or (b) directly or indirectly, substantial common direction. For example, the local chapter of a national fraternity or of the Red Cross is related to its national organization.

Any tax-exempt entity is related to any other entity if either owns 50 percent or more of the capital interests or the profit interests in the other. For example, a foreign person is related to its wholly-owned subsidiary and any corporation that owns 50 percent or more of the value of its stock, and a section 501(c)(3) organization is related to any corporation 50 percent or more of the stock of which it owns. For purposes of this rule, an entity treated as related to any other entity under either of the two foregoing rules will be treated as the one entity. For example, assume that each of 10 cities within 1 State own 10 percent of a corporation. The State, each city and the corporation are related parties.

Any tax-exempt entity is related to any other tax-exempt entity with respect to a particular transaction if such transaction is part of an attempt to avoid the application of the bill.

11. Exceptions

The bill does not apply to mass commuting vehicles exempted from most of TEFRA's amendments to the safe harbor lease provisions. See section 208(d)(5) of P.L. 97-248. Furthermore, the bill does not apply to property described in section 208(d)(3)(E) of P.L. 97-248, as amended by P.L. 97-448 (relating to certain boilers and turbines of rural electric cooperatives). Nor does the bill apply to property described in section 168(f)(12)(C)(ii) (relating to certain sewage or solid waste disposal facilities) of present law if a ruling request relating to the tax consequences of the use of such property by a tax-exempt entity was filed on or before May 23, 1983.

The bill does not apply to any motion picture film or video tape described in section 48(k)(1)(B) (relating to motion picture films and video tapes created primarily for public entertainment or educational purposes) used by any foreign person or entity. However, no inference is intended as to whether motion picture films and video tapes can qualify as recovery property.

12. Regulations

The bill provides that the Treasury is to prescribe such regulations as may be necessary or appropriate to carry out the purposes of new section 168(j). However, no such regulations are to be inconsistent with the bill, as reflected in its legislative history.

D. Effective Date

General

The bill applies to property placed in service by the taxpayer after May 23, 1983, except to the extent acquired by the taxpayer subject to a lease in effect on May 23, 1983. The bill also applies to property placed in service by the taxpayer before May 24, 1983, and used pursuant to a lease entered into or renewed after May 23, 1983. For purposes of the preceding sentence, a lease will not be treated as entered into or renewed after May 23, 1983, merely by reason of the exercise by a lessee of a written option, or performance under a contract, enforceable against the lessor on May 23, 1983, and at all times thereafter. Furthermore, property will not become tax-exempt use property merely because a lessee under a lease entered into before May 24, 1983, subleases to a tax-exempt entity after May 23, 1983.

Transitional rules

The bill has three general effective date transitional rules.

First transitional rule

Under the first transitional rule, the bill does not apply to property used by a tax-exempt entity pursuant to one or more written contracts binding on May 23, 1983, and at all times thereafter, which required the taxpayer (or a predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate the property and the tax-exempt entity (or a tax-exempt predecessor in interest under the contract) to use the property.

For example, assume that on February 1, 1983, a tax-exempt entity enters into a binding contract to have a building constructed. Construction is to be completed on January 15, 1984. On May 1, 1983, the tax-exempt entity assigns its interest in the construction contract to corporation X and enters into a binding contract to lease the building back from corporation X upon its completion. The first transitional rule applies. However, the first transitional rule would not apply if the assignment and entering into of the binding contract to lease did not occur until after May 23, 1983.

As a further example, assume that a tax-exempt entity has owned and occupied all of a building for years. On May 1, 1983, the tax-exempt entity enters into a binding contract with corporation Y pursuant to which the tax-exempt entity, on July 1, 1983, will sell the building to corporation Y and lease it back. The first transitional rule applies. The result would be the same even if corporation Y assigns its entire interest in the contract to corporation Z, or contributes it to a partnership of which it is a member, on June 1, 1983. And the result would be the same if the tax-exempt entity assigned its interest in the lease to another tax-exempt entity on June 15, 1983.

A contract is binding only if it is enforceable under State law against the taxpayer (or a predecessor) and does not limit damages to a specified amount as, for example, by a liquidated damages provision. A contract that limits damages to an amount equal to at least 5.0 percent of the total contract price will not be treated as limiting damages. A contract is binding even if subject to a condition, so long as the condition is not within the control of either party (or a predecessor). A contract will not be treated as ceasing to be binding merely because the parties make insubstantial changes in its terms or if any term is to be determined by a standard beyond the control of either party. Finally, a contract which imposes significant obligations on the taxpayer (or a predecessor) will not be treated as non-binding merely because some terms remain to be negotiated. For example, if a corporation and a tax-exempt entity enter into a legally enforceable contract on May 1, 1983, pursuant to which the corporation agrees to buy a building from the tax-exempt entity and then lease it back, the contract will be treated as a binding contract to use notwithstanding the fact that some terms of the lease have not yet been set.

On the other hand, a binding contract to acquire a component part for a larger piece of property will not be treated as a binding contract to acquire the larger piece of property. For example, if a tax-exempt entity entered into a binding contract on May 1, 1983, to acquire a new aircraft engine, there would be a binding contract to acquire only the engine, not the entire aircraft.

Second transitional rule

Under the second transitional rule, the bill does not apply to property (a) which the taxpayer (or a predecessor in interest under or in the contract) or the tax-exempt entity was required to acquire, construct, reconstruct, or rehabilitate pursuant to a contract that was binding on May 23, 1983, or has commenced but not completed construction, reconstruction, or rehabilitation by May 23, 1983, if (b) the tax-exempt entity either (i) by December 31, 1983, enters into a binding contract to use the property or (ii) had, on May 23, 1983, and at all times thereafter, a firm plan, evidenced in writing, to enter into a contract for its use. Requirement (a) above will not be satisfied if the tax-exempt entity (or a related party) used the property before May 24, 1983, except that property acquired before May 24, 1983, and after December 31, 1982, or property the construction, reconstruction, or rehabilitation of which is completed after December 31, 1982, and before May 24, 1983, will be treated as meeting that requirement. Property does not fail the completion-of-construction test merely because a certificate of completion was not issued.

For example, assume that a tax-exempt entity acquires and begins using a building on November 1, 1982. On February 1, 1983, the tax-exempt entity enters into a binding contract to have the building rehabilitated. The rehabilitation is to be started on March 1, 1983, and completed by May 1, 1984. By May 1, 1983, the tax-exempt entity has a firm plan, evidenced in writing, to enter into a sale-leaseback of both the original building and the rehabilitation. On January 15, 1984, pursuant to the firm plan, a binding agreement to sell and lease back is entered into. On these facts, the second transitional rule applies to the rehabilitation but not to the original building (since it was acquired and used before January 1, 1983). Assuming the requirement in (a) above was satisfied, the same result would follow even if the tax-exempt entity had no firm plan to do a sale-leaseback prior to May 24, 1983, if a binding sale-leaseback agreement is entered into before the end of 1983. If the tax-exempt did not acquire and use the building until January 15, 1983, the second transitional rule would apply to it as well.

For purposes of this transitional rule, the contract to acquire, construct, reconstruct, or rehabilitate need not be with the seller or the construction company. It is sufficient if the taxpayer (or a predecessor) or the tax-exempt entity has a contract with any person requiring the taxpayer (or a predecessor) or the tax-exempt entity to acquire, construct, reconstruct, or rehabilitate. For example, a binding contract between a taxpayer and a tax-exempt entity pursuant to which the taxpayer is obligated to have property constructed for the tax-exempt entity qualifies as a binding contract for purposes of the second transitional rule. The other rules applicable under the first transitional rule with respect to assignments of contracts and binding contracts are equally applicable under the second transitional rule.

A firm plan to enter into a contract for the use of property exists if the tax-exempt entity had planned to contract for the use of the property and, under all the circumstances, it was reasonable to expect that the tax-exempt entity or a successor tax-exempt entity would in fact enter into a contract to use the property. A firm plan would not be treated as existing if the tax-exempt entity merely retained professional advisors to advise it, generally or with respect to a particular transaction, even if such advisor had recommended that the tax-exempt entity lease the property involved. A firm plan would exist, however, if the governing body of the tax-exempt entity, its chief executive, any other person authorized to speak for it, or its paid professional staff approved the recommendation and it was reasonable to expect the tax-exempt entity to enter into a contract for the use of the property involved in the recommendation. A firm plan would also exist if the tax-exempt entity historically entered into contracts for the use of similar property, absent indications to the contrary. For example, assume that a foreign airline contracts to have aircraft manufactured for it, with completion scheduled for 1985. The foreign airline has leased the last 5 planes manufactured for it, and there are no indications that the new planes will not also be leased. The foreign airline has a firm plan.

Satisfactory written evidence of a firm plan would include minutes of meetings, written correspondence from representatives of the tax-exempt entity, letters of intent executed by the tax-exempt entity, written solicitation of proposals from the tax-exempt entity to prospective lessors, and, in the case of a firm plan purportedly based on custom, written evidence of the historical practices relied upon. If a firm plan existed on May 23, 1983, it would be in all events treated as continuing through the date of enactment. For example, assume that in January, 1983, a tax-exempt entity's governing body adopted a resolution authorizing the entity's staff to proceed with negotiations for a sale-leaseback agreement. The minutes of the governing body's meeting include the text of the resolution. The resolution related to a building under construction since December, 1982 pursuant to a contract that was binding on May 23, 1983. The second transitional rule applies to the building.

Third transitional rule

Under the third transitional rule, the bill does not apply to property constituting part of a project which was approved by significant official governmental action on or before May 23, 1983, and with respect to which significant sums were paid or incurred on or before May 23, 1983, so long as the tax-exempt entity by December 31, 1983, enters into a binding contract to use the property. For purposes of this rule, significant official governmental action approving design work for a project will be treated as significant official governmental action approving the project. The third transitional rule cannot apply if the tax-exempt user of the property is the Federal government, any agency or instrumentality thereof, or a foreign person but can apply if the tax-exempt user is a State or local government unit or any other tax-exempt entity.

For example, assume that prior to May 24, 1983, a city council approved a plan providing for the rehabilitation of city hall. Also prior to May 24, 1983, the city expended significant funds for architectural services with respect to the rehabilitation. On December 1, 1983, the city enters into a binding contract to sell the rehabilitated city hall to private investors and lease it back. Prior to May 24, 1983, the city had no plan to sell the building and lease it back.

The third transitional rule is applicable with respect to the entire building, as rehabilitated.

For purposes of the third transitional rule, whether particular property is part of an approved project, or a project for which design work had been approved, depends on all the facts and circumstances, including the tax-exempt entity's plans on May 23, 1983.

The payment or incurrence, by the taxpayer, the tax-exempt entity, a related party, any predecessor of any of the foregoing, or any governmental unit or other participant in the project of sums equal to the lesser of $100,000 or .5 percent of the estimated cost of a project would be treated as the payment or incurrence of significant sums. A binding obligation, conditioned only on the performance of services by a third party, to expend sums will be treated as an expenditure of such sums. Sums paid or committed to independent third parties, including out-of-pocket expenditures, will be counted for purposes of this rule, but amounts paid or incurred with respect to the tax-exempt entity's staff, other employees, or general overhead allocable to the project or its design work will not. Sums will be considered expended notwithstanding the fact that reimbursement might be made by the lessor or some other party. Sums will also be considered incurred notwithstanding the fact that liability contingent on substantial completion of the project involved.

A project (or design work with respect to a project) will be considered as having been approved by significant official governmental action if the governing body having authority to commit the tax-exempt entity to the project (or the design work), to provide funds for it, or to approve the project (or the design work) under State or local law took significant action indicating an intent to proceed with, provides funds for, or approve the project (or the design work) and it would be reasonable, under all the circumstances, to expect that the project (or the design work) would be carried out. As an example, assume that in December, 1982, the State agency regulating hospitals in the State issues a certificate of need to a tax-exempt entity with respect to a specific hospital project. The official governmental action rule is satisfied.

The significant official governmental action rule contains three separate requirements. First, the action must be an official action. Second, the action must be specific action approving a particular project. And third, the action must be taken by a governing body having authority to commit the tax-exempt entity to the project, to provide funds for it, or to approve the project under State or local law.

Under the first requirement, the governing body must adopt a resolution or ordinance, or take similar official action, prior to May 24, 1983. The action qualifies only if it conforms with Federal, State or local law and is a proper exercise of the powers of the governing body. Moreover, the action must not have been withdrawn. Finally, written evidence of the action must have existed before May 24, 1983. Satisfactory written evidence includes a formal resolution or ordinance, minutes of meetings, and contracts with third parties pursuant to which the third parties are to render services in furtherance of the project.

The second requirement is directed at the substance of the action taken. The action must be a specific action with respect to a particular project in which the governing body indicates an intent to have the project (or the design work for it) proceed. This requires that a specific project have been formulated and that the significant official action be a step toward consummation of the project. If the action does not relate to a specific project or merely directs that a proposal or recommendation be formulated, it will not qualify. On the other hand, no plan to lease needs to have been formulated by May 23, 1983. Generally, a significant official action would include the hiring of bond counsel or bond underwriters necessary to assist in the issuance and sale of bonds to finance a particular project or the adoption of an inducement resolution relating to bonds to be issued for such a project. It would also include making application for an Urban Development Action Grant on behalf of the project described in the application or receipt of a governmental grant with respect to the project. It would also include the recommendation of a city planning authority to proceed with a project based on the results of an authorized feasibility study.

Under the third requirement, the action must be taken by a governing body (Federal, state, or local) having authority to commit the tax-exempt entity to the project, to provide funds for it, or to approve the project under applicable law. If the chief executive or another representative of a governing body has such authority, action by such representative would satisfy the official governmental action requirement so long as it qualified as official action and related to a particular project, regardless of whether such action might later be rescinded. A governing body may have the authority to commit the tax-exempt entity to a project notwithstanding the fact that the project cannot be consummated without other governmental action being taken. For example, a city council will be treated as having authority to commit a city to do a sale-leaseback of its city hall notwithstanding the fact that State law needs to be amended to permit such a transaction. Similarly, if a local project cannot be completed without Federal approval, either legislative or administrative, the obtaining of such approval will qualify as official governmental action.

However, routine governmental action at a local level will not qualify as official governmental action. Routine governmental action includes the granting of building permits or zoning changes and the issuance of environmental impact statements.

Partnerships

The provisions of section 168(j)(8) (relating to partnerships which have tax-exempt as well as taxable partners) are not applicable to partnerships which were organized before October 21, 1983 and which conclude marketing of partnership interests within 90 days after the date of enactment in a dollar amount not greater than the amount announced before October 21, 1983, as the maximum to be raised. This rule applies only with respect to property acquired by such partnerships prior to 1985.

Certain waste water treatment facilities

Waste water treatment facilities which are used by a tax-exempt entity and which are not 15-year real property are to be depreciated on the straight-line method over 12 years, using the half-year convention and disregarding salvage value, if, by June 15, 1983, a city council approved entering into a lease and, by July 12, 1983, a resolution was adopted approving the issuance of industrial development bonds to finance acquisition of the facilities by the taxpayer.

E. Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $683 million in 1984, $990 million in 1985, $1,740 million in 1986, $3,070 million in 1987, $4,877 million in 1988, and $6,978 million in 1989.

C. Treatment of Bonds and Other Debt Instrument

1. Market Discount (sec. 41 of the bill and new secs. 1276, 1277, and 1278 of the Code)

Present Law

Market discount arises when the value of a debt obligation declines after issuance (typically, because of an increase in prevailing interest rates). Capital gain treatment is accorded to the appreciation in value attributable to market discount on an obligation that was issued by a corporation or governmental unit and held for more than one year (sec. 1232). In many cases, interest on indebtedness incurred to purchase or carry a market discount bond is deductible currently against ordinary income, even though the income eventually generated by the investment is not taxed until disposition (and then only at capital gain rates).

Reasons for Change

The committee recognizes that, from the standpoint of the holder of a bond, market discount is indistinguishable from original issue discount (OID). In each case the discount is a substitute for stated interest, and the holder of the obligation receives some of his return in the form of price appreciation when the bond is redeemed at par upon maturity. When a taxpayer makes a leveraged purchase of a market discount bond, the taxpayer effectively converts the ordinary income that is offset by current interest deductions to capital gain that is taxed on a deferred basis.

It has come to the Committee's attention that tax-shelter transactions have arisen in which taxpayers acquire market discount bonds using borrowed funds, to take advantage of the opportunities under present law to defer tax liability on ordinary income and to convert ordinary income to capital gain. The Committee appreciates that the theoretically correct treatment of market discount, which would require current inclusion in the income of the holder over the life of the obligation, would involve administrative complexity. However, the Committee believes that the present-law rules should be modified to prevent the use of market discount bonds as a basis for tax-shelter transactions, under an approach that would be more easily administered and complied with by taxpayers.

Explanation of Provisions

Overview

The bill generally requires that gain on disposition of a market discount bond be recognized as interest income, to the extent of accrued market discount (computed under a linear formula). The bill also limits a taxpayer's ability to take current interest deductions on indebtedness incurred to purchase or carry a market discount bond. The bill provides an election to include accrued market discount in income currently. Neither the rule requiring ordinary income treatment on disposition nor the rule limiting interest deductions would apply to bonds with respect to which the election is made.

Accrued market discount treated as ordinary income

Except as otherwise provided by the bill, gain on the disposition of any market discount bond is treated as interest income to the extent of accrued market discount, for all purposes of Federal income taxation (including, for example, the statutory provision that limits the deductibility of investment interest). Characterization of the market discount as interest would not affect the issuer of the bond. For purposes of this rule, a taxpayer who disposes of a bond in a transaction other than a sale, exchange, or involuntary conversion (*e.g.*, by making a gift) is treated as realizing an amount equal to the fair market value of the bond. Under regulations to be prescribed by the Secretary, certain transfers will be excepted from the provisions of the bill. The bill provides that regulations will include rules similar to those of section 1245(b), relating to transfers excepted from the depreciation recapture rules, with certain modifications (including that no exception will be provided for gifts, and that market discount will not be included in income if a bond is transferred in the course of certain tax-free reorganizations). Appropriate adjustments will be made to the basis of any property to reflect gain recognized under the provisions of the bill.

Definition of market discount bond

The bill defines a bond as any bond, debenture, note, certificate, or other evidence of indebtedness. Except as provided by the bill, the term "market discount bond" means any bond having market discount. Exceptions are provided for obligations (i) with a fixed maturity not exceeding one year from date of issue, (ii) the interest on which is not includible in the gross income of the holder under section 103, relating to certain governmental obligations (or any other provision of law that provides for tax exemption without regard to the identify of the holder), or (iii) which is a U.S. savings bond.

Treatment of substituted basis property

If a taxpayer transfers a market discount bond in a nonrecognition transaction excepted from the provisions of the bill, and the basis of the property received in exchange is determined in whole or in part by reference to the basis of the transferred bond, then the property received in such transaction (referred to as "exchanged basis property") is treated as a market discount bond.

Definition of market discount

Market discount is defined as the excess of the stated redemption price of a bond over the adjusted basis of such bond immediately after its acquisition by the taxpayer. For OID bonds acquired at a market discount, the stated redemption price is treated as equal to its "revised issue price" (defined as the sum of the issue price of the bond and the aggregate amount of the OID includible in the gross income of all holders for periods before the bond was acquired by the taxpayer). Under a de minimis rule, market discount is considered to be zero if the market discount is less than .25 of 1 percent of the stated redemption price at maturity, multiplied by the number of complete years to maturity after the taxpayer acquired the bond.

Linear computation of accrued market discount

Accrued market discount is computed by determining the amount that bears the same ratio to the market discount on the bond as (i) the number of days that the taxpayer held the bond, bears to (ii) the number of days after the date the taxpayer acquired the bond up to (and including) the date of maturity. Thus, the market discount is treated as accruing in equal daily installments during the period the bond is held by the taxpayer.

Accrued market discount on substituted basis property

With respect to a market discount bond that is "transferred basis property" (generally, property received in a nonrecognition transaction excepted from the bill, the basis of which is determined by reference to its basis in the hands of the transferor), the transferee is treated as having acquired the bond on the date when it was acquired by the transferor for an amount equal to the adjusted basis (increased for gain recognized by the transferor on the transfer). The amount of accrued market discount with respect to exchanged basis property includes any accrued market discount to the extent such amount was not previously treated as interest income under the provisions of the bill.

Election to accrue market discount under an economic accrual formula

At the election of the taxpayer, accrued market discount can be computed by using the constant interest method that is provided by present law for the amortization of OID on bonds issued after July 1, 1982. The constant interest method parallels the manner in which interest would accrue through borrowing with interest-paying nondiscount bonds.

Deferral of interest deduction allocable to accrued market discount

The bill limits a taxpayer's ability to take current deductions for interest on indebtedness incurred to purchase or carry a market discount bond. The taxpayer's net direct interest expense is allowed as a deduction only to the extent that the expense exceeds the amount of market discount allocable to the days during the taxable year on which the bond was held by the taxpayer. The term "net direct interest expense" is defined as the excess of the interest paid or accrued by the taxpayer over the interest (including OID) includible in gross income for the taxable year with respect to such bond.

Interest that is deferred under this rule is allowed as a deduction for the taxable year when the taxpayer disposes of the market discount bond. If the bond is disposed of in a transaction in which gain is not recognized in whole or in part, the deferred interest is allowed as a deduction at that time to the extent of recognized gain.

To the extent deferred interest is not allowed as a deduction upon the disposition of a bond in a nonrecognition transaction, the disallowed interest expense will be treated as disallowed interest expense with respect to transferred-basis or exchanged-basis property received in the transaction. Thus, in the case of a market discount bond that is transferred-basis property, the transferee will be entitled to deduct the disallowed interest expense upon disposition of the bond.

Election to include accrued market discount in income currently

The bill provides an election to include accrued market discount in gross income for the taxable years to which it is attributable. Under this provision, market discount can be accrued under the economic accrual formula or the linear formula at the election of the taxpayer. If the taxpayer makes an election, neither the rule requiring ordinary income treatment upon disposition nor the interest-deferral rule would apply to bonds acquired during the period the election is in effect. The election to accrue market discount currently cannot be revoked without the consent of the Secretary.

Effective Date

The provision requiring the recognition of interest income on disposition of a market discount bond will apply to obligations issued after the date of enactment of the bill. The provision that defers interest deductions on indebtedness incurred to purchase or carry market discount bonds will apply to obligations acquired after the date of enactment of the bill.

Revenue Effect

The revenue effects of this provision are included in the estimates of the revenue effects of the provision relating to discount on short-term obligations.

2. Discount on Short-term Obligations (sec. 41 of the bill and new secs. 1281, 1282, and 1283 of the Code)

Present Law

In general, periodic inclusion of original issue discount is required of the holders of debt obligations (sec. 1232A). However, a special rule is provided by statute for governmental obligations (Treasury bills) that are issued at a discount and payable without interest at a fixed maturity not exceeding one year. For Treasury bills, discount is not considered to accrue until the obligation is paid at maturity or otherwise disposed of (sec. 454(b)). This rule applies regardless of the character of the obligation in the hands of the holder (*e.g.*, as inventory or a capital asset). Furthermore, on disposition of the instrument, the taxpayer's capital gain or loss is computed with reference to accrual of the acquisition discount, not the original issue discount. Under Treasury regulations, there is no accrual of original issue discount on certain short-term obligations (*e.g.*, certificates of deposit) held by cash-basis taxpayers (Treas. reg. sec. 1.1232-3(b)(1)(iii)).

In many cases, interest on indebtedness incurred to purchase obligations eligible for the special rules can be deducted currently against unrelated income, thereby generating a one-year tax deferral.

Reasons for Change

The special rules that permit deferral of acquisition discount on Treasury bills and original issue discount on short-term discount obligations are commonly used to defer tax liability on ordinary income. For this reason, the Committee concluded that the scope of these rules should be reviewed. The rationale for allowing tax deferral on Treasury bills has been that the tax benefit from a one-year deferral is not large enough to warrant subjecting taxpayers to the additional complexity of accrual accounting. However, this argument clearly does not apply to taxpayers who use the accrual method of accounting for their other income and deductions for income tax purposes, or for the purpose of reporting to shareholders or creditors. With high interest rates, the balance between simplicity and the tax benefit from a one-year deferral has shifted towards greater concern over the revenue loss arising from the tax deferral allowed under present law. The Committee also is concerned that taxpayers have been making leveraged purchases of obligations eligible for the special rule at year-end to achieve tax deferral. Only for the ordinary investor making unleveraged purchases of Treasury bills or other short-term discount obligations does the Committee believe that the present tax deferral remains appropriate.

Explanation of Provision

Overview

The bill limits the scope of the special rules permitting deferral of acquisition and original issue discount on short-term obligations. In addition, the bill limits the ability to use leveraged purchases of short-term discount obligations within the special rules to defer tax on ordinary income. An election is provided, under which taxpayers who remain eligible for the special rules can avoid application of the interest deferral rule by electing to include discount in income as it accrues.

Current inclusion of discount in income

Under the bill, certain holders of short-term governmental obligations are required to include in gross income the daily portions of acquisition discount for each day during the taxable year on which the obligations are held. This provision applies to short-term obligations held by (i) any taxpayer using an accrual method of accounting, (ii) any bank (as defined in section 581), (iii) any taxpayer who holds the obligation for sale to customers in the ordinary course of the taxpayer's trade or business, and (iv) a taxpayer who identifies the obligation as being part of a hedging transaction under section 1256(e)(2) (generally, a transaction executed in the normal course of a trade or business primarily to reduce certain risks and that results only in ordinary income or loss).

Definition of short-term obligation

The bill generally defines "short-term obligation" to mean any bond, debenture, note, certificate, or other evidence of indebtedness that has a fixed maturity date not exceeding one year from the date of issue. Exceptions are provided for obligations the interest on which is not includible in gross income under section 103 (relating to interest on certain governmental obligations), or any other provision of law that provides for tax-exemption without regard to the identity of the holder.

Definition of acquisition discount

Acquisition discount is defined as the excess of the stated redemption price at maturity (as defined for purposes of the rules requiring the periodic inclusion of OID), over the taxpayer's basis for the obligation.

Computation of daily portions of acquisition discount

The bill generally provides that the daily portion of the acquisition discount is equal to (i) the amount of such discount, divided by (ii) the number of days after the day on which the taxpayer acquired the obligation and up to (and including) the day of its maturity. The application of this provision results in the linear accrual of the acquisition discount. However, under regulations prescribed by the Secretary, taxpayers may elect to accrue acquisition discount under an economic accrual formula, pursuant to which the daily portion of the discount is computed on the basis of the taxpayer's yield to maturity based on the cost of acquiring the obligation, compounded daily. The election to account for acquisition discount under an economic-accrual method is irrevocable.

Short-term obligations other than governmental obligations

The bill provides that rules similar to the rules described above apply to original issue discount on short-term obligations other than governmental obligations held by cash-basis taxpayers.

Deferral of interest deduction allocable to accrued discount

For taxpayers who remain eligible for the special rule permitting tax deferral, the bill limits the ability to make leveraged purchases of short-term governmental obligations as a device to defer tax on ordinary income. The net direct interest expense with respect to a short-term obligation (as defined for purposes of applying the bill) is allowed as a deduction only to the extent of the daily portions of the acquisition discount for each day on which the taxpayer held the obligation during the taxable year. The term "net direct interest expense" is defined in the same manner as that term is used for purposes of the provision that defers interest deductions allocable to accrued market discount (generally, the excess of interest paid or accrued over interest includible in gross income with respect to the obligation).

For purposes of the interest deferral rule, rules similar to the rules applicable to market discount bonds will apply (including the allowance of deductions for deferred interest upon disposition of the bond and the treatment of substituted-basis property).

Election to include acquisition-discount in income currently

The interest deferral rule does not apply to a taxpayer who elects to include acquisition discount in income under the rules applicable to accrual-basis and other taxpayers. If the election is made, the provision requiring current inclusion will apply to all short-term obligations acquired by the taxpayer on or after the first day of the first taxable year to which the election applies. The election cannot be revoked for subsequent taxable years without the consent of the Secretary.

Short-term obligations other than governmental obligations

Rules similar to the rules described above apply with respect to leveraged purchases of OID short-term obligations other than governmental obligations by cash-basis taxpayers.

Effective Date

The provision relating to the treatment of acquisition and original issue discount will be effective for obligations acquired after the date of enactment. Taxpayers may elect to treat the change to an accrual basis for their short-term discount obligations as a change in their method of accounting so that their increased taxable income may be spread over 10 years. They may also elect to accrue interest on their short-term discount obligations with respect to all such obligations held during the taxable year including the date of enactment.

Revenue Effect

The revenue gain from these changes, and the changes involving market discount bonds, is expected to be $72 million in fiscal year 1984, $146 million in 1985, $150 million in 1986, $153 million in 1987, $155 million in 1988, and $158 million in 1989.

3. Original Issue Discount on Tax-Exempt Bonds (sec. 41 of the bill and new sec. 1288 of the Code)

Present Law

In general, interest on obligations issued by any political subdivision of a State is exempt from Federal income taxation (sec. 103(a)). On the basis of long-standing administrative practice, the Internal Revenue Service ruled that original issue discount (OID) on an obligation issued by a municipality is similarly exempt from tax. (Rev. Rul. 73-112, 1973-1 C.B. 47, restating G.C.M. 10452, X-1 C.B. 18 (1932)). The Internal Revenue Service further ruled that tax-exempt OID is apportioned on a straight-line basis over the term of the obligation among the original holder and subsequent purchasers.

Prior to 1982, holders of OID bonds issued by corporations were also required to apportion OID on a straight-line basis over the term of the obligation. The Tax Equity and Fiscal Responsibility Act of 1982 included a provision that requires the economic accrual of OID on bonds issued by corporations and other entities.

Reasons for Change

The application of a straight-line interest computation to discount municipal obligations may permit the holder of a deep-discount municipal bond to generate an artificial loss by disposing of the bond prior to maturity. This result could occur because the holder's amount realized on disposition, for purposes of determining gain or loss, is reduced by the amount treated as accrued tax-exempt OID, even though the market price of the bond is likely to reflect the (slower) economic accrual of interest.

Recently, there has been a significant increase in the issuance of zero coupon tax-exempt bonds. The Committee is concerned that taxpayers may acquire these obligations to generate tax losses to shelter income. Although it appears to be the position of the Internal Revenue Service that no loss is allowable based on the linear accrual of tax-exempt OID, some taxpayers have claimed that such losses are allowable. The committee believes that OID on zero coupon municipal bonds should be accrued in the same manner as that provided for OID on obligations issued by corporations and other juridical entities. The committee intends no inference regarding the proper treatment of obligations acquired before the effective date of the bill.

Explanation of Provision

The bill requires the holders of discount obligations to accrue tax-exempt OID by using the constant interest method provided by present law for the holders of obligations issued by corporations and other entities. Under the bill, the basis of an obligation is increased by the amount of accrued tax-exempt OID. Thus, the holder of a zero coupon municipal bond will be able to claim economic losses realized on disposition of the bond. The bill also adopts a simplifying assumption for the determination of the issue price of tax-exempt OID bonds. Under this rule, in the case of an issue of bonds sold to the public, the issue price is considered to be the initial offering price to the public (other than bond houses and brokers) at which price a substantial number of the bonds were sold. This rule, which applies under current law where taxable bonds are sold for cash in a public offering, has the effect of insuring that all bonds in an issue have a single issue price.

Effective Date

This provision is effective for obligations issued after September 3, 1982 (the date of enactment of the Tax Equity and Fiscal Responsibility Act) and acquired after March 1, 1984.

Revenue Effect

This provision is estimated to reduce fiscal year receipts by $3 million in 1984, $5 million in 1985, $7 million in 1986, and $8 million in 1987.

D. Tax Treatment of Corporations and Their Shareholders

1. Debt-financed Portfolio Stock (sec. 51 of the bill and sec. 245A of the Code)

Present Law

In general, a corporate shareholder can deduct 85 percent of dividends received from other corporations. Because the maximum rate of tax on corporate ordinary income is 46 percent, the maximum effective rate of tax on dividends received by a corporation is only 6.9 percent. When a corporation borrows the funds used to purchase dividend-paying stock, interest on the acquisition indebtedness generally is deductible against ordinary income. In some cases, these rules may permit corporations to make debt-financed portfolio stock investments which, but for the tax laws, would be uneconomic.

Reasons for Change

The purpose of the dividends received deduction is to prevent multiple taxation of income as it flows from the corporation that earns it to the ultimate noncorporate shareholder. When a corporation borrows money to finance purchases of portfolio stock, the conjunction of a dividends received deduction and an interest deduction can result in avoidance of substantial corporate-level taxes on corporate earnings. The problem is aggravated to the extent the distributing corporation is not paying full corporate taxes owing to the use of various tax preferences.

Explanation of Provision

The bill reduces the allowable dividends received deduction for dividends with respect to debt-financed portfolio stock (defined below).

Debt-financed portfolio stock

With respect to any dividend distribution, the term "debt-financed portfolio stock" is defined as any stock of a corporation if (i) as of the beginning of the ex-dividend date, the taxpayer does not own at least 50 percent of the total combined voting power of all classes of stock and at least 50 percent of the total number of all other classes of stock of the distributing corporation, and (ii) at some time during the base period there is portfolio indebtedness with respect to such stock. For purposes of this definition, the term base period means, with respect to any dividend distribution, the shorter of (i) the period beginning on the ex-dividend date for the most recent previous dividend on the stock and ending on the day before the ex-dividend date for such dividend, or (ii) the one-year period ending on the day before the ex-dividend date for such dividend.

The bill defines the term portfolio indebtedness to mean any indebtedness that is directly attributable to an investment in stock with respect to which a dividend is received. The bill contemplates that the directly attributable requirement will be satisfied if there is a direct relationship between the debt and an investment in stock. The bill does not contemplate the use of any allocation or apportionment formula or fungibility concept. Thus, for example, the bill does not apply merely as a result of (i) the existence of outstanding commercial paper that is issued by a corporation as part of an ongoing cash management program or (ii) deposits received by a depositary institution as a part of the ordinary course of its business. However, if indebtedness is clearly incurred for the purpose of acquiring dividend-paying stock or otherwise is directly traceable to such an acquisition, the indebtedness would constitute portfolio indebtedness. Thus, if stock is held in a margin account with a securities broker, the margin borrowing constitutes portfolio indebtedness. The same result would follow with respect to any nonrecourse loan secured, in whole or in part, by dividend-paying stock.

Certain amounts received from a short sale treated as indebtedness.—For purposes of the definition of portfolio indebtedness, any amount received by the taxpayer as proceeds of a short sale is treated as indebtedness of the taxpayer for the period beginning on the day on which such amount is received and ending on the day after the short sale is closed.

Controlled group of corporations.—The portfolio indebtedness is not required to be that of the holder of the dividend-paying stock to satisfy the directly attributable test of the bill. Thus, for example, the bill could apply to a case where one member of an affiliated group of corporations incurs the portfolio indebtedness and another member of the group acquires the dividend-paying stock.

Computation of allowable deduction

In lieu of the 85-percent deduction that is generally available (sec. 243(a)(1), sec. 244(a)(3), and sec. 245), the bill limits the deduction to a percentage determined by computing the product of 85 percent and 100 percent minus the average indebtedness percentage. Under regulations prescribed by the Secretary, the average indebtedness percentage is obtained by dividing (i) the average amount of the portfolio indebtedness with respect to the stock during the base period, by (ii) the average amount of the adjusted basis of the stock during the base period. However, under regulations prescribed by the Secretary, any reduction in the amount allowable as a dividends received deduction under the rule is to be limited to the amount of the interest deduction allocable to the related dividend (including short sale expenses related to short positions treated as debt for purposes of determining the average indebtedness percentage).

Special rule where stock is not held throughout the base period

For any stock that is not held by the taxpayer throughout the base period, the rules are applied by (i) taking into account only the portion of the base period during which the stock was held, and (ii) adjusting the average indebtedness percentage by multiplying the figure obtained under the general rule by a fraction the numerator of which is the number of days during the base period on which the taxpayer held the stock and the denominator of which is the number of days during the base period.

Exceptions

The bill provides exceptions for dividends eligible for the 100-percent dividends received deduction (generally determined under section 243(b)), and for dividends received by a small business investment company operating under the Small Business Investment Act of 1958.

Effective Date

The provision applies to stock the holding period for which begins after the date of enactment, in taxable years ending after such date.

Revenue Effect

The revenue gain is expected to be less than $10 million per year.

2. Certain Dividends from Regulated Investment Companies (sec. 52 of the bill and sec. 854(b) of the Code)

Present Law

Domestic corporations are generally entitled to a dividends received deduction with respect to dividends includible in their gross income. No similar deduction is available with respect to interest income. Furthermore, mutual funds, or regulated investment companies ("RICs"), are generally not subject to Federal income taxes if they distribute their income to shareholders. If less than 75 percent of a RIC's gross income consists of dividends from domestic corporations, then the distributions to the RIC's corporate shareholders are treated as part dividends, part other income, on a pro rata basis. However, if at least 75 percent of a RIC's gross income consists of dividends from domestic corporations, then all the amounts distributed by the RIC are treated as dividend income to such shareholders even though up to 25 percent of the RIC's gross income may consist of, say, interest income (sec. 854(b)).

The foregoing rules permit a taxpayers to convert interest income into dividend income. Taxpayers have organized RICs to take advantage of this conversion opportunity.

Reasons for Change

The committee believes that present law provides an opportunity for the conversion into dividend income of interest income and other kinds of income which is unwarranted.

Explanation of Provision

The bill requires that 100 percent, rather than 75 percent, of a RIC's gross income constitute dividend income in order for all its distributions to be treated as dividend income eligible for the 85 percent dividends received deduction for corporate shareholders. If less than 100 percent of RIC's gross income constitutes dividend income, then only a portion of such distributions are to be treated as dividend income for purposes of computing the dividends received deduction. That portion is to be determined under the present-law allocation rules.

Effective Date

The provision is effective for all taxable years of a RIC beginning after the date of enactment of the bill.

Revenue Effect

The effects of this provision are included in the estimated revenues for other provisions.

3. Corporate Shareholder's Basis in Stock Reduced by Reason of Extraordinary Dividends (sec. 53 of the bill and secs. 246(c), 301(e), and 1059 of the Code)

Present Law

A corporation owning stock of another corporation generally is allowed a deduction equal to 85 percent of the amount of any dividends received with respect to that stock. However, the deduction is disallowed unless the stock is held for more than 15 days (more than 90 days in the case of preference dividends attributable to a period or periods aggregating more than 366 days). In determining whether the holding period requirement is satisfied, any period during which the taxpayer has an option to sell, is contractually obligated to sell, or has made (and not closed) a short sale of, substantially identical stock or securities is excluded. The deduction is also disallowed if the taxpayer is under an obligation, pursuant to a short sale or otherwise, to make a payment corresponding to the dividend with respect to substantially identical stock or securities.

Gains and losses from the sale of capital assets are generally long-term if the assets have been held by the taxpayer for over 1 year, and short-term if held for 1 year or less. Net short-term gain (short-term gains exceeding short-term losses) is taxed at the maximum corporate rate of up to 46 percent to the extent it exceeds any net long-term loss.

Under present law, the receipt of a dividend by a corporate shareholder generally has no effect on the shareholder's basis in the stock with respect to which the dividend was received. As a result, a domestic corporation, for example, can buy shares of stock in another corporation in anticipation of receiving an extraordinary dividend that will be eligible for the dividends received deduction and that will reduce the value of the stock. After receiving the dividend, the corporation can sell the stock and claim the loss resulting from the decline in value of the stock as a short-term capital loss. The short-term loss will offset unrelated short-term gain which may otherwise be taxable at the maximum corporate tax rate of 46 percent. The transaction results in counterbalancing such gain with dividend income taxable at an effective rate of 6.9 percent. Thus, although the transaction will result in little or no economic cost or loss, a tax benefit of up to $0.391 per dollar of dividend income may be available.

If the dividend consists of appreciated property, the amount of the dividend and the basis of the distributed property in the hands of the corporate shareholder will be its basis in the hands of the distributing corporation (adjusted for any gain recognized to the distributing corporation on the distribution). Furthermore, because the property has a carryover basis in the hands of the distributee, the period the property was held by the distributing corporation is tacked onto the distributee shareholder's holding period in determining whether gain realized on a subsequent disposition is long-term or short-term (sec. 1223(2)). Thus, if the distributed property has a low basis relative to its value and had been held by the distributing corporation for over a year, its sale by the corporate shareholder would result in long-term capital gain, subject to the alternative corporate capital gain tax rate of 28 percent, while a sale of the stock would result in a short-term loss. Alternatively, the corporate shareholder could contribute the distributed property to charity and be allowed a deduction for its full fair market value (sec. 170(e)(1)(A)).

In recent years, publicly-held oil companies have transferred royalty interests carved out of long-held working interests in oil and gas leases to trusts and distributed units of interest in the trusts to their shareholders. The distribution of the units of interest generally is regarded as a dividend fully taxable to noncorporate shareholders but, for a corporate shareholder, the dividend is generally regarded as subject to the treatment applicable to dividends of property outlined above. When a dividend distribution of interests in a royalty trust is announced, a domestic corporate taxpayer can obtain such beneficial treatment by purchasing the stock before the dividend is paid and, after receiving the dividend and after satisfying the holding period requirement applicable with respect to the dividends received deduction (generally more than 15 days), sell the stock and dispose of the distributed property. To the extent the property has a low or zero basis in the hands of the distributing corporation, the need to satisfy the holding period requirement diminishes or disappears.

Similarly, if the distribution is of long-held property with a low basis relative to its value, it does not matter if the distribution does not qualify as a dividend. To the extent of the appreciation, a corporate shareholder would be in a position to convert short-term capital gain into long-term capital gain. To the extent of the property's basis, such a conversion would not be possible because present law already provides for a reduction in the stock basis in such a case (sec. 301(c)(2)).

Reasons for Change

Present law has generated several types of tax-motivated transactions which the committee believes should be discouraged. First, in the case of large dividends, corporations are buying stock shortly before the ex-dividend date and selling shortly after. They deduct a short-term capital loss on the stock and 85-percent of the dividend. For a corporation with a short-term capital gain, this transaction, in effect, converts that gain into 85-percent exempt income.

Second, when the distribution consists of appreciated property, corporations can convert short-term capital gain to long-term gain by selling the distributed property along with the stock. They get a short-term capital loss on the stock and a long-term capital gain on the distributed property.

Third, some corporations are engaging in straddle-like transactions by buying a dividend-paying stock and selling short similar securities (like convertible bonds). If the property sold short is not substantially identical, the dividends received deduction can be claimed the short-sale expenses deducted in full against ordinary income. In effect, these transactions convert ordinary income into 85 percent exempt income.

When a stock pays an extraordinary dividend, the acquisition of the stock often may be viewed as the acquisition of two assets: the right to distributions to be made with respect to the stock and the underlying stock itself. In instances in which the acquisition of stock is the acquisition of two assets, the committee concludes that it is appropriate to reduce the basis of the underlying stock to reflect the value of the distribution not taxed to a corporate distributee. In the committee's view, the failure of present law to apply a two asset analysis in cases of extraordinary distributions when the taxpayer's holding period in the stock is short, leads to tax arbitrage opportunities of the type described above.

Also, present law denies the dividends received deduction in cases in which the taxpayer has entered into another position that significantly reduces, or eliminates, his risk of loss with respect to the stock. However, these rules are not comprehensive, and the committee believes they should be tightened.

Explanation of Provision

The bill provides for a reduction in the basis of a share of stock held by a corporate shareholder by the non-taxed portion of any non-liquidating extraordinary dividend received with respect to such share if the share is sold or exchanged before it has been held by the taxpayer for more than 1 year. Extraordinary dividends are those which, in amount, equal or exceed 5 percent, in the case of a share of stock preferred as to dividends, and 10 percent, in the case of any other share of stock, of the corporate shareholder's adjusted basis in such share (determined without regard to this rule). All dividends received with respect to a share of stock which have ex-dividend dates within a period of 90 consecutive days are to be aggregated and treated as one dividend in determining whether the 5 percent or 10 percent test is met. Furthermore, all dividends received with respect to a share of stock which have ex-dividend dates during a period of 365 consecutive days are to be treated as extraordinary if their amounts aggregate more than 20 percent of the corporate shareholder's adjusted basis in such share. The basis reduction resulting from any extraordinary dividend is to occur at the beginning of the ex-dividend date for such dividend. Special rules are provided for dividends received with respect to shares of stock having a substituted basis.

For purposes of the new rules, the amount of any distribution is, in the case of a distribution of property other than cash, the fair market value of the distributed property at the time of the distribution. The non-taxed portion of any dividend is the amount of the dividend, as so determined, less any portion thereof includible in gross income and not offset by a dividends received deduction. However, for purposes of measuring the amount of a distribution for purposes of section 301(b)(1)(B)(ii) and section 301(d)(2), present law is not changed.

For purposes of determining whether the holding period requirement has been satisfied, rules similar to those governing the more-than-15-day requirement applicable to the dividends-received deduction are to be applied. In addition, any period during which the taxpayer is the grantor of an option to buy substantially identical stock or securities or has another position or positions which substantially diminish the taxpayer's risk of loss from holding the stock would also be excluded from the holding period (as well as from the more than 15- and more than 90-day holding periods of present law). This functional analysis of whether risk reduction has occurred supplements the narrower rule of present law which excludes only the period during which the taxpayer holds a put, a short position, or a binding contract to sell stock or securities that are substantially identical to the dividend-paying stock. However, a holding period is not to be reduced merely by reason of the taxpayer's having written a qualified covered call (as defined in new section 1092(d)(6)). Nor is the dividends received deduction to be denied merely because the stock itself has a low risk. For example, a corporation holding only one position—preferred stock the dividend rate on which changes periodically so as to maintain the market value of the stock at or near its stated value—will not, absent other facts, lose the dividends received deduction with respect to that stock.

For purposes of the new rules, a distribution which, had it qualified as a dividend, would have been an extraordinary dividend is to be treated as an extraordinary dividend even though the distributing corporation has no current or accumulated earnings and profits. In such a case, the amount of the distribution is to be reduced by the amount of any reduction in basis resulting from the application of section 301(c)(2).

In the case of any distribution of appreciated property with respect to a share of stock, whether or not a dividend and whether or not extraordinary, the distributee corporate shareholder shall not be treated as acquiring the property before the date on which it acquired such share if its basis in the property is determined with reference to its basis in the hands of the distributing corporation under section 301(d)(2).

The Secretary is authorized to prescribe such regulations as may be appropriate to carry out the purposes of the new rules, including regulations governing their applicability in the case of stock dividends, stock splits, reorganizations, and other similar transactions.

Effective Date

Except for the holding period rules, the foregoing provisions apply to distributions after March 1, 1984, in taxable years ending after that date. The holding period provisions are generally applicable to stock acquired after the date of enactment, in taxable years ending after such date, except that the provision preventing a distributee from tacking on the holding period of the distributing corporation is effective for dividends declared after the date of enactment.

Revenue Effect

These provisions will increase fiscal year budget receipts by $140 million in 1985, $100 million in 1986, $100 million in 1987, $100 million in 1988, and $100 million in 1989.

4. Distributions of Appreciated Property by Corporations (sec. 54 of the bill and sec. 311(d) of the Code)

Present Law

Under present law, a corporation generally does not recognize income on the distribution, with respect to its stock, of property. There are several exceptions to this rule. First, such a distribution will generally trigger recapture, as under section 1245 (relating to depreciable personal property). Second, the distribution of inventory accounted for on a LIFO basis will give rise to ordinary income to the extent of the difference between what the inventory amount of such inventory would have been had it been accounted for on a FIFO basis and what the inventory amount of such inventory is on the LIFO basis (sec. 311(b)). Third, if a corporation distributes property which is subject to a liability, or the shareholder assumes a liability of the corporation in connection with the distribution, gain is generally recognized to the corporation to the extent such liability exceeds the adjusted basis of the distributed property as if the property had been sold (sec. 311(c)). Fourth, if a corporation distributes property in a redemption to which sections 301 through 307 apply and the fair market value of such property exceeds its adjusted basis, gain in an amount equal to the excess is recognized to the corporation as if the property had been sold.

There are also several exceptions to the rule requiring recognition of gain with respect to distributions of property in a redemption to which sections 301 through 307 apply. First, gain is not recognized with respect to distributions in a redemption of stock of a certain corporate shareholders if the basis of the distributed property to the distributee is determined with reference to its adjusted basis in the hands of the distributing corporation (sec. 311(d)(2)(A)). Second, gain is not recognized with respect to certain distributions in redemption of stock of noncorporate shareholders if the distribution qualifies as a partial liquidation (sec. 311(d)(2)(B)). Third, gain is not recognized with respect to distributions in a redemption of stock qualifying under section 311(e)(2) (relating to distributions of stock or securities of certain controlled corporations to persons holding qualified stock, as defined in section 311(e)) or section 303(a) (relating to distributions to pay death taxes), certain distributions to private foundations, and certain distributions by regulated investment companies.

Reasons for Change

In many situations, present law permits a corporation to distribute appreciated property to its shareholders without recognizing the gain. In such a case, if the distributee is an individual, the basis of the property will be stepped up without any corporate-level tax having been paid (although the individual shareholder will often have dividend income in an amount equal to the fair market value of the property). The committee believes that under a double-tax system, the distributing corporation generally should be taxed on any appreciation in value of any property distributed in a non-liquidating distribution. For example, had the corporation sold the property and distributed the proceeds, it would have been taxed. The result should not be different if the corporation distributes the property to its shareholders and the shareholders then sell it. Furthermore, if the shareholder is a corporation, present law generally permits gain on distributed property to be deferred, until the shareholder sells it. The committee generally believes that deferral to be inappropriate.

Explanation of Provisions

Under the bill, gain (but not loss) is generally recognized to the distributing corporation on any ordinary, non-liquidating distribution, whether or not it qualifies as a dividend, of property to which subpart A (secs. 301 through 307) applies as if such property had been sold by the distributing corporation for its fair market value rather than distributed. The general rule applies whether or not there is a redemption of stock.

If the distribution is in a redemption of stock, the present-law exceptions to the recognition of gain generally remain. However, gain is to be recognized if the distribution in redemption is to a domestic corporate shareholder unless such shareholder is then an 80 percent or more shareholder, that is, unless it owns, at the time of the distribution, stock possessing at least 80 percent of the total combined voting power of all classes of stock of the distributing corporation and at least 80 percent of the total number of all other classes of stock of the distributing corporation (not including non-voting stock which is limited and preferred as to dividends). Furthermore, the distributee is not to be treated as an 80 percent or more shareholder unless the distributee's basis in the distributed property is determined with reference to its basis to the distributing corporation (determined without regard to this section).

If the distribution is not in a redemption of stock, gain is to be recognized in full unless the distribution is to a corporation that at the time of the distribution is an 80 percent or more shareholder (as determined above).

In addition, if the distribution is not in a redemption of stock, gain is not to be recognized to the distributing corporation with respect to property distributed to a shareholder other than a corporation in a qualified dividend. A qualified dividend is a distribution of property which is a dividend, is of property used by the distributing corporation immediately before the distribution in the active conduct of a trade or business, and is not property described in section 1221(1) relating to inventory or certain other assets) or section 1221(4) (relating to certain accounts and notes receivables). Furthermore, the dividend must be with respect to qualified stock, as defined in section 311(e). The committee intends that the distribution of property described in either such section is to be treated as made out of earnings and profits to the extent thereof.

The committee intends no change in the applicability of the recapture rules of present law, except as indicated.

The bill also provides that section 311(b) (relating to distributions of LIFO inventory) and section 311(c) (relating to liabilities in excess of adjusted basis) are to be applied before any of the other provisions. Thus, for example, assume that a corporation distributes LIFO inventory to an individual shareholder not in a redemption of stock. Assume further that the LIFO inventory amount is $100, its FIFO inventory amount is $125, and the inventory is worth $120. The distribution corporation would have ordinary income of $25. If the inventory is worth $130, the distributing corporation would have ordinary income of $30.

Effective Date

The provisions are effective with respect to distributions declared after the date of enactment of the bill in taxable years ending after such date. However, the provisions do not apply to certain distributions of any interests in a royalty trust made before February 1, 1986.

Revenue Effect

This provision will increase fiscal year budget receipts by $3 million in 1984, $18 million in 1985, $64 million in 1986 and $114 million in 1987.

5. Capital Gains Distributions from Regulated Investment Companies and Real Estate Investment Trusts (sec. 55 of the bill and secs. 852(b)(4) and 857(b)(7) of the Code)

Present Law

Generally, regulated investment companies ("RICs") that distribute their income are not subject to Federal income taxes. Rather, that income is taxed directly to their shareholders.

RICs frequently realize long-term capital gain income. That income is generally treated as long-term capital gain income to the shareholders. Under these rules, a person can buy stock of a RIC immediately before the ex-dividend date of a distribution of long-term capital gain income by the RIC and sell the stock shortly thereafter. The distribution will reduce the value of the stock so that the shareholder will have a loss when he sells it. Under present law, if the stock is held for less than 31 days, the loss, to the extent of any long-term capital gain resulting from the distribution, is treated as long-term capital loss. However, if the shareholder holds the stock for 32 days but not more than 1 year, the loss, if capital in character, is short-term. Similar rules apply with respect to real estate investment trusts.

Under these rules, a person can convert short-term capital gain into lower-taxed long-term capital gain by buying RIC or REIT stock immediately before the ex-dividend date of a long-term capital gain distribution, waiting 32 days, and then selling the stock.

Reason for Change

The committee believes that present law offers too much of an opportunity to convert short-term into long-term capital gain. The committee believes that the 31-day holding period requirement should be lengthened to discourage taxpayers from making tax-motivated purchases of RIC or REIT stock shortly before ex-dividend dates for capital gains distributions.

Explanation of Provision

If a shareholder of a RIC or REIT holds its stock for less than 6 months, any loss recognized on the sale of such stock is to be treated as long-term capital loss to the extent of any distribution to him with respect to such stock which is treated as long-term capital gain. There is an exception for dispositions of stock pursuant to a periodic redemption plan. In determining how long a shareholder has held stock of a RIC or REIT for this purpose, rules similar to those of section 246(c)(3) and section 246(c)(4), as amended by the bill, are to apply.

Effective Date

The provisions are applicable to losses incurred on stock with respect to which the taxpayer's holding period begins after the date of enactment of the bill.

Revenue Effect

This provision will increase fiscal year budget receipts by $83 million in 1986 and $89 million in 1987.

6. Denial of Deductions for Certain Expenses Incurred In Connection with Short Sales (sec. 56 of the bill and secs. 163(d), 263, and 265 of the Code)

Present Law

If a distribution becomes payable on stock with respect to which the taxpayer has made a short sale, the taxpayer is generally required to pay an amount equal to the fair market value of the distribution to the lender of the stock sold short. The Internal Revenue Service has ruled that this payment in lieu of a dividend is fully deductible. Rev. Rul. 72-521, 1972-2 C.B. 178; and Rev. Rul. 62-42, 1962-1 C.B. 133. In general, the stock may be expected to decline in value by an amount equivalent to the fair market value of the distribution, and the taxpayer can close out the short sale and realize a short-term capital gain equal to the dividend substitute payment. Net capital loss from other transactions, the deductibility of which would otherwise be limited, may be deducted against the short-term gain from the short sale and be replaced by a current deduction against ordinary income.

Present law limits the deduction of investment interest generally to an amount equal to net investment income plus $10,000. Investment interest is defined as interest paid or accrued on indebtedness incurred or continued to purchase or carry investment property but does not specifically include any amount to carry personal property used in a short sale. Present law also disallows a deduction for interest relating to tax-exempt interest but does not specifically extend the disallowance to costs to purchase or carry property used in a short sale.

Reasons for Change

The short sale transaction described above provides a means to avoid the limitations on the deductibility of capital losses through a scheme lacking economic substance. A taxpayer may sell stock short just before the ex-dividend date, deducting his payment in lieu of the dividend against ordinary income, and realize an offsetting short-term capital gain upon closing the short sale. Capital losses, whose deductibility against ordinary income is limited, may be deducted against the short-term capital gain. For a taxpayer with both long-term capital gain and short-term capital loss, the transaction is also attractive, because it, in effect, converts ordinary income into long-term capital gain.

In the case of large dividends, these short sale transactions prior to ex-dividend dates are widely used to avoid tax. For example, Chrysler Corp. recently paid a large dividend on 10 million shares of preferred stock. At the time of the ex-dividend date, short sales of the preferred stock exceeded 6 million shares.

Furthermore, costs incurred in a short sale for the use of property to produce investment income or exempt interest have the same function relative to such investment income or exempt interest as interest, the deduction of which is limited or disallowed under present law. The committee believes that the tax treatment of interest and short sale expenses should be conformed.

Explanation of Provision

The bill disallows the deduction of any amount paid by reason of the payment of a distribution on stock used by the taxpayer in a short sale if the short sale is closed on or before 15 days after the date of the short sale (on or before the day one year after the date of the short sale in the case of any amount paid by reason of an extraordinary dividend, generally as defined in sec. 53 of the bill). The amount disallowed as a deduction is charged to capital account and added to the basis of the stock used to close the short sale.

In determining how long a short sale is kept open, there is not to be included any period during which the taxpayer holds, has an option to buy, or is under a contractual obligation to buy, substantially identical stock or securities or is otherwise substantially protected from the risk of loss from the short sale by reason of the holding of 1 or more positions.

The provisions restricting the deduction of investment interest and disallowing interest relating to tax-exempt interest are extended to costs incurred to carry property used in a short sale which are not required to be capitalized as described above. This rule is applicable regardless of whether the property sold short is equity or debt.

Effective Date

The above provisions are applicable with respect to amounts paid or incurred after the date of enactment, in taxable years ending after such date.

Revenue Effect

This provision will increase fiscal year budget receipts by $22 million in 1984, $32 million in 1985, $38 million in 1986, $43 million in 1987, $48 million in 1988, and $54 million in 1989.

7. Warrants (sec. 57 of the bill and sec. 1032 of the Code)

Present Law

Prior to the Tax Reform Act of 1976, gain to the grantor of an option to buy property arising from the failure of the holder to exercise it generally resulted in ordinary income to the grantor. In Rev. Rul. 72-198, 1972-1 C.B. 223, the Internal Revenue Service stated its position that the general rule applied with respect to warrants issued by a corporation to acquire its own stock, reasoning that warrants are a kind of option. Under the Service's position, a corporation would have $2 of ordinary income if a warrant it issued for $2 lapsed without being exercised. Similarly, the Service has allowed a corporation to deduct a loss if it bought back warrants to acquire its own stock for more than it received upon their issuance.[1]

The Service's position is arguably inconsistent with some old case law. For example, *Illinois Rural Credit Association*, 3 B.T.A. 1178 (1926), held that subscription payments made to a corporation as a down payment on the purchase of stock of the corporation were not includible in the corporation's income when they were forfeited to the corporation. The transaction was viewed as capital in character.

The Tax Reform Act of 1976 changed the rules applicable to options to buy property (sec. 1234). Under those rules, gain or loss to the grantor of an option from any closing transaction with respect to, and gain on the lapse of, such an option is treated as short-term capital gain or loss. However, the legislative history of the new rules indicated that Congress was aware of, and taking no position on, the question whether a corporation realizes income when warrants to purchase its stock from it expire unexercised, or lapse. The Service continues to adhere to its position that warrants should be treated like other options.

Present law treats the issuance of notes and warrants together as coming within the investment unit rules of the original issue discount rules.

Section 1032 provides that a corporation recognizes no gain or loss on the receipt of money or other property in exchange for its stock. Furthermore, a corporation does not recognize gain or loss when it redeems its stock, with cash, for less or more than it received when the stock was issued.

Reasons for Change

Present law can put the Service into an unacceptable position. If a corporation issues a warrant for $2 and buys it back for $1, it is likely to argue that, notwithstanding Rev. Rul. 72-198, it recognizes no income, citing *Illinois Rural Credit Association* and other authorities. If the corporation's stock goes up in value and the corporation buys the warrant back for $3, it is likely to claim a loss, citing Rev. Rul. 72-198. The committee desires to end this discontinuity. Furthermore, the committee believes that the repurchase of a warrant by the issuing corporation should not produce different tax consequences to the corporation than an exercise of the warrant followed by a repurchase by the corporation of the newly issued stock.

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[1] *See*, e.g., LTR 8023025 (February 28, 1980) and LTR 7745009 (July 28, 1977).

Explanation of Provision

Under the bill, a corporation does not recognize gain or loss on the issuance of a warrant or on any lapse or repurchase of the warrant.

Effective Date

The provision is applicable to warrants acquired or lapsing after the date of enactment of the bill, in taxable years ending after such date.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $5 million annually.

8. Accumulated Earnings Tax (sec. 58 of the bill and secs. 532 and 535(b) of the Code)

Present Law

Section 531 *et seq.* impose an accumulated earnings tax on a corporation that is formed or availed of for the purpose of avoiding the income tax with respect to shareholders by permitting earnings and profits to accumulate instead of being distributed. The fact that a corporation is a mere holding or investment company is *prima facie* evidence of a tax avoidance motive. In the case of other corporations, an accumulation of earnings and profits beyond the reasonable needs of the business is determinative of a tax avoidance purpose unless the corporation proves to the contrary.

Where applicable, the accumulated earnings tax is imposed at a rate of 27 1/2 percent of the first $100,000 of accumulated taxable income and at a rate of 38 1/2 percent of accumulated taxable income in excess of $100,000. The term "accumulated taxable income" means taxable income, with certain adjustments, reduced by a deduction for any dividends paid. In determining accumulated taxable income, a corporation is permitted to deduct any net capital loss during the year in question. However, a net capital loss is not allowed as a deduction against taxable income (but can be carried back or forward as a deduction against capital gain). A corporation is also permitted to deduct from accumulated taxable income its net capital gain, determined without regard to capital loss carrybacks or carryovers, less taxes attributable to such capital gain.

Reasons for Change

The deduction from accumulated taxable income for net capital losses was introduced in 1936. Presumably, its purpose was to permit a corporation to accumulate income in order to restore losses sustained in the course of its business. While there may have been ample justification for the deduction in 1936, there is little justification today. As a result of a series of provisions enacted beginning in 1939, business losses are now very seldom treated as capital losses.

The special deduction for net capital losses is particularly difficult to justify in the case of a mere holding or investment company. Allowing such a company to deduct net capital losses is inconsistent with the treatment of qualified regulated investment companies and real estate investment trusts. These entities are required to distribute a high percentage of their income annually and, for this purpose, net capital losses are not allowed as a deduction in determining their income.

A rather elaborate scheme has been utilized by a number of investment companies to exploit the special deduction from accumulated taxable income for net capital losses. Under this scheme, an investment company that does not elect to be taxed as a regulated investment company is formed to accumulate dividend income, with the intention that neither the shareholders nor the corporation itself will pay more than a minimal amount in current taxes. Its stock is widely-held.

The corporation's assets are invested primarily in dividend-paying stock so that, for the most part, the corporation's income will be dividends eligible for the 85-percent dividends received deduction. To the extent of slightly more than the remaining 15 percent of income, the corporation will have deductible expenses consisting of management fees, brokerage fees, interest, and other items. Consequently, the corporation will have no regular taxable income. The 85 percent dividends received deduction will not shield the corporation from the accumulated earnings tax, however, because the dividends received deduction is added back to taxable income in computing accumulated taxable income.

Initially, the corporation may contend that because its shares are publicly-held, it is not subject to the accumulated earnings tax. However, if the corporation is nominally subject to the accumulated earnings tax, it may avoid actual liability for the tax almost completely by carefully structuring the timing of its capital gains and losses. For example, the corporation might for several years arrange to realize an annual capital loss equal to the amount of dividends received during the year (less operating expenses). Because net capital losses are allowed as a deduction from accumulated taxable income, the corporation would not be subject to the accumulated earnings tax in these years.

The corporation then might take all of its capital gains in one year. These capital gains would not be subject to regular income tax to the extent that they are offset by the capital losses sustained in earlier years. Moreover, these capital gains for the most part would not be subject to the accumulated earnings taxes. The allowance of a deduction for net capital losses as well as a deduction for net capital gains realized in subsequent years (not reduced by capital loss carryovers), less taxes attributable thereto, in determining accumulated taxable income effectively permits the capital losses to be taken into account twice.

The committee knows of no reason why widely-held companies should be automatically exempt from the accumulated earnings tax. Nor can it justify the deductions from accumulated taxable income of both net capital losses and net capital gains, as permitted under present law.

Explanation of Provisions

The bill clarifies that the mere fact that the stock of a corporation is widely-held does not exempt it from imposition of the accumulated earnings tax. This rule applies to operating companies as well as mere holding or investment companies.

Under the bill, the deduction from accumulated taxable income for net capital gain, less taxes attributable thereto, remains. Nor is any change made in the method of determining the taxes attributable to the net capital gain. However, in determining net capital gain during any taxable year for this purpose, net capital loss for any prior taxable years shall be treated as short-term capital loss during such taxable year. Furthermore, the deduction from accumulated taxable income for net capital loss sustained during the taxable year generally remains. However, that latter deduction is subject to reduction.

In general, the reduction is equal to any deduction from accumulated taxable income, for preceding taxable years beginning after December 31, 1984, for net capital gain, less regular taxes attributable thereto. However, in no event is the same net capital gain, less taxes attributable thereto, to be used to reduce the deduction for net capital loss more than once. Furthermore, if the corporation's accumulated earnings and profits as of the close of the preceding taxable year are less than the reduction that would otherwise be made for a taxable year, the reduction for that taxable year is to be limited to the amount of such accumulated earnings and profits.

The rule of present law that capital loss carrybacks and carryforwards do not reduce accumulated taxable income remains.

Two special rules are provided for mere holding or investment companies, as that term is applied under the accumulated earnings tax provisions. First, they are allowed no deduction from accumulated taxable income for net capital loss. Second, for all purposes of subchapter C (sec. 301 through sec. 385), accumulated earnings and profits shall not be less than they would have been had section 535(b), as amended by the bill, applied to all taxable years beginning after the date of enactment.

Effective Date

The provisions relating to the determination of accumulated taxable income apply to all taxable years beginning after the date of enactment of the bill.

Revenue Effect

This provision will increase fiscal year budget receipts by $62 million in 1985, $78 million in 1986, and $33 million in 1987.

9. Exchange of Debt for Stock (sec. 59 of the bill and sec. 108 of the Code)

Present Law

Under present law, income is realized when indebtedness is forgiven or in other ways cancelled (sec. 61(a)(12)). For example, if a corporation issues bonds at par and later repurchases the bonds at less than par, the difference is taxable at that time. Present law (sec. 108) provides that income from the discharge of indebtedness of a corporation may be excluded from income if the corporation reduces the basis in depreciable property. This allows the corporation to, in effect, defer the income. Special rules apply to title 11 (bankruptcy) cases and to corporations which are insolvent.

Cases have held that there is an exception to the rule for income on discharge of indebtedness where a corporate debtor issues its own stock to cancel its indebtedness.[2] This exception was grounded on the theory that the stock was simply a substitute liability for the debt and that no event had occurred which should cause the recognition of income. However, the exception is applied notwithstanding the fact that the stock may be substantially different than the debt obligation, or that the value of the stock issued is substantially less than the debt cancelled.

Reasons for Change

Under present law, a corporation is treated differently where it issues stock to discharge its debts than where it raises new capital by a stock issuance and uses that capital to discharge its outstanding debts. The latter case would give rise to income from the discharge of indebtedness. Present law also allows a corporation which retires existing indebtedness for stock and then issues new indebtedness with a lower principal amount and a higher interest rate to obtain a larger interest deduction, notwithstanding that total debt payments (principal and interest) may have remained unchanged.

For these reasons, the committee believes that the so-called "stock-for-debt" exception should be repealed, for solvent corporations outside of a title 11 proceeding.

Explanation of Provision

The bill treats a corporation which issues stock in cancellation of its debt in the same manner as if it had satisfied the indebtedness with an amount of money equal to the fair market value of the stock. Thus, the corporation will have income from the discharge of indebtedness to the extent the principal of the debt exceeds the value of the stock (and other property transferred, if any) exceeds the principal of the debt.

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[2] See, for example, *Motor Mart Trust* v. *Comm'r*, 156 F.2d 122 (1st Cir. 1946).

This rule will not apply to insolvent corporations or to corporations in a title 11 case.

Effective Date

The provision will apply to transfers or stock issuances after the date of enactment of the bill.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $5 million annually.

10. Distributions By a Corporation of Debt Obligations Having a Fair Market Value Less Than Par (sec. 60 of the bill)

Present Law

A distribution by a corporation constitutes a dividend only if out of current or accumulated earnings and profits. The fair market value of property distributed as a dividend is includible in the gross income of an individual shareholder.

A corporation can distribute as a dividend its own debt obligations. Those obligations may have a fair market value less than their face amount. That is, they may carry a stated interest rate which is below the prevailing market rate. In such a case, an individual shareholder would have dividend income in an amount equal to the value of the obligations distributed to him. But the corporation may contend that, under present law, it can reduce its earnings and profits by the principal amount of such obligations (sec. 312(a)). The result could be to eliminate earnings and profits at the cost of a relatively small dividend tax. Distributions made by a corporation with no earnings and profits are not dividends but a return of capital.

Furthermore, taxpayers may argue that, under present law, such an obligation is not subject to the original issue discount rules. If that is correct, a shareholder on the cash basis may report no income with respect to the discount until it is paid, and the income may qualify as capital gain. Similarly, an accrual basis obligor may claim interest deductions currently on a straight-line or ratable rather than a constant rate basis, thereby accelerating deductions of the discount.

Reasons for Change

The committee does not believe that a dividend distribution should reduce earnings and profits by more than the amount includible as a dividend in the gross income of an individual recipient of such a distribution. Furthermore, the committee believes that obligations distributed by a corporation that bear economic discount should be subject to the general original issue discount rules.

Explanation of Provisions

In the case of a dividend distribution by a corporation of its own debt securities at a discount, the corporation's earnings and profits are to be reduced by the issue price of the securities at the time of the distribution (determined under the original issue discount rules). Furthermore, any such securities are to be subject to the original issue discount rules. No inference is intended as to the proper treatment with respect to such securities under present law.

Effective Date

These provisions apply to obligations distributed after the date of enactment.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $10 million annually.

11. Consolidated Returns (sec. 61 of the bill and Sec. 1504 of the Code)

Present Law

In general, an affiliated group of corporations has the privilege of filing consolidated Federal income tax returns. Once a group commences filing such returns, it must generally continue to do so.

Section 1504 defines the term affiliated group. Under that definition, an affiliated group means 1 or more chains of includible corporations connected through stock ownership with a common parent which is an includible corporation if (i) stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each includible corporation (except the common parent) is owned directly by 1 or more other includible corporations, and (ii) the common parent owns directly at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock of at least 1 of the other includible corporations. For purposes of this rule, nonvoting stock which is limited and preferred as to dividends is disregarded, as is certain other stock. Under section 1504(b), certain corporations cannot qualify as includible corporations.

One of the many reasons corporations file consolidated returns is to permit one corporation to make use of tax benefits (e.g., net operating losses and credits) generated by another corporation that cannot itself make actual use of the benefits.

Reasons for Change

Present law permits some unintended results in certain situations. For example, a common situation involves a new venture which is expected to generate tax losses or credits and which is to be undertaken by a corporation which is not itself in a position to use those tax benefits (e.g., a foreign corporation not otherwise engaged in the U.S.). That corporation will find a corporate partner that can use the tax benefits. The venture will be incorporated with a capital structure consisting of two classes of common stock. The first, Class A, will be a normal common stock. The other, Class B, will also be a normal common stock except that it will have only minimal voting rights and will be convertible into Class A common stock at any time in a ratio permitting it to obtain voting control. The profitable corporate partner acquires all the Class A stock for $400, and the loss corporate partner acquires all the Class B stock for $1,600. Because of the differences in voting rights, the Class A stock possesses 80 percent of the voting power of all classes of stock of the newly-incorporated venture.

Under present law, the incorporated new venture and the profitable corporate partner would likely file consolidated returns, even though the profitable corporate partner owns only 20 percent in value of the venture and even though the Class B stock will likely be converted into Class A stock after some period of time. The profitable corporation would own stock possessing 80 percent of the venture's voting power, and the venture would have no nonvoting stock outstanding. The applicability of section 269 (relating to acquisitions made to avoid tax) in such a case is uncertain.

Other devices might be used under present law to produce a result similar to that above. For example, the venture may issue a carefully-written convertible preferred stock or warrants to the loss partner instead of a convertible Class B common stock.

The committee believes that the devices described above, and similar devices, are little more than a form of tax-benefit transfer. In effect, the loss corporate partner is in significant part selling its venture's losses to the profitable corporate partner. The committee also believes that two corporations should not be permitted to commence filing consolidated returns unless one owns a significant percentage of the value of the other, as well as stock possessing at least 80 percent of the voting power of it.

Explanation of Provisions

Under the bill, 2 includible corporations are not eligible to elect to file a consolidated return with respect to any taxable year unless at the beginning of such taxable year, one owns stock possessing at least 80 percent of the voting power of all classes of stock, and at least 80 percent of the fair market value of all outstanding stock, of the other. For this purpose, stock is not to include nonvoting stock which is limited and preferred as to dividends and in liquidation unless it is convertible into stock which is not so limited and preferred. Nor is it to include certain other stock not treated as stock under section 1504 of present law.

While the Internal Revenue Service ordinarily will not issue a ruling as to the value of a stock interest, the Service has issued rulings describing various valuation methodologies. The committee contemplates that the Service will continue to issue such rulings.

Once 2 corporations have filed a valid consolidated return for any period, they will not cease being members of the affiliated group until the common parent no longer owns stock, determined as above, possessing (i) 80 percent or more of the voting power of all classes of stock or (ii) more than 50 percent of the fair market value of all outstanding stock, of the other. Once a corporation ceases to be a member of an affiliated group filing a consolidated return, neither it nor a successor can rejoin that same affilliated group (or another affiliated group of which the former common parent, or a successor, is a member), for 5 taxable years, unless the Secretary consents, conditionally or otherwise.

Similar rules apply in determining whether other corporations may join an affiliated group and, if so, under what circumstances any such corporation would cease being a member of the group.

Code references to section 1504 (other than those in sections 1501 through 1564) are to refer to such section as it existed prior to the effective date of the bill.

The bill authorizes the Secretary to prescribe all necessary and appropriate regulations, including anti-abuse regulations, to implement the purposes of this section. This regulations are to include provisions under which, in the appropriate circumstances (i) warrants to acquire stock of a corporation from that corporation and convertible securities of that corporation are to be treated as having been exercised or converted, (ii) options to acquire stock held by another person are to be treated as having been exercised, (iii) decreases in voting power disproportionate to decreases in the total value of all classes of stock are to be disregarded, (iv) stock is not to be treated as stock, and (v) plans in effect at the time of consolidation to reduce the ownership of the value of all outstanding stock of another corporation below 80 percent shall nullify status as an affiliated group.

Effective Date

The provision is effective for taxable years beginning after December 31, 1984. However, the provision is not applicable to corporations which were members of the same affiliated group, determined without regard to the bill, on March 1, 1984. Their status as members of the same affiliated group shall continue to be determined under present law. Once any such member ceases to be a member of that group, as determined under present law, the bill's provisions will apply to it, including to rule prohibiting reconsolidation for 5 years.

Revenue Effect

This provision will increase fiscal year budget receipts by $11 million in 1985, $29 million in 1986 and $48 million in 1987.

E. Partnership Provisions

1. Partnership Allocations With Respect to Contributed Property (sec. 71 of the bill and sec. 704 of the Code)

Present Law

Partnership allocations generally.—A partner's distributive share of partnership income, gain, loss, deduction, or credit (or items thereof) is generally governed by the partnership agreement (sec. 704(b)). However, if the allocation provided by the agreement does not have substantial economic effect, these items are reallocated for tax purposes in accordance with the partner's interest in the partnership, determined by taking into account all facts and circumstances. Proposed Treasury regulations provide that, in general, an allocation has economic effect if (1) the allocation is reflected by an appropriate increase or decrease in the partner's capital account, (2) liquidation proceeds (if any) are to be distributed in accordance with the partners' capital account balances, and (3) any partner with a deficit in his capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the partnership. The economic effect of the allocation must be substantial in relation to the tax effect for the allocation provided for the agreement to be valid.[1]

Property contributed to a partnership.—Under present law (sec. 704(c)), when property is contributed to a partnership, the partnership may (but is not required to) allocate depreciation, depletion, on gain or loss with respect to the contributed property so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. If the partnership does not make allocations on this basis, the allocations are made as if the property had been purchased by the partnership.

A shifting of income or losses among partners that does not reflect the economic burdens borne by the parties may occur if a partnership does not elect to allocate depreciation, depletion and gain or loss with respect to contributed property so as to take account of the variation between the basis and the fair market value of the contributed property but instead permits sharing of items related to the contributed property in accordance with the interest of the partner. For example, if partner A contributes property with a basis of $200 and a value of $100 while partner B contributes $100 in cash to a partnership, the initial capital accounts of the partners may each be set at $100 (the fair market value of their contributions). Some taxpayers contend that absent specific allocations of the loss under the partnership agreement, a subsequent sale of the property for $100 would result in an allocation of $50 of loss to each partner, thereby shifting $50 of loss from A to B. The pre-contribution loss would be effectively reallocated to the contributing partner if the partnership were liquidated; however, the shifting of the loss could be effective so long as the partnership remained in existence. Some taxpayers contend that a similar shifting of gain can be accomplished in the case of a contribution of appreciated property to a partnership.

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[1] Prop. Treas. Reg. sec. 1.704-1(b)(2)(ii), 48 Fed. Reg. 9871 (March 9, 1983).

Reasons for Change

Although the committee believes that the underlying theory of the present law partnership provisions that taxpayers should be able to pool their resources for productive uses without triggering gain or loss is appropriate, it believes that special rules are needed to prevent an artificial shifting of tax consequences between the partners with respect to pre-contribution gain or loss. This is particularly important since the various partners may have different tax positions. For example, a partner to whom gain could be shifted in the absence of the bill's provisions could be tax-exempt, could have a lower marginal rate than the contributing partner, or could have expiring net operating loss carryovers.

Explanation of Provision

The bill provides a new rule regarding allocations with respect to property contributed to a partnership. Under the new rule, depreciation, depletion, and gain or loss with respect to items of contributed property are to be shared among the partners, pursuant to Treasury regulations, so as to take account of the variation between the partnership's basis for the property and the fair market value of the property at the time of contribution. It is anticipated that regulations under this provision generally will provide for the same result that is achieved under present law when a partnership elects with respect to all relevant items to provide for sharing of depreciation, depletion, and gain or loss among the partners so as to take into account fully the variation between the basis of the property of the partnership and its fair market value at the time of the contribution.[2] Thus, a partnership will generally be required, rather than being permitted to elect (as under present law), to allocate "built-in" gain or loss on contributed property to the contributing partner. It is anticipated that the regulations will permit partnerships to agree to a more rapid elimination of disparity among partners than required by the new rules by substituting items not described in section 704(c) for items described in section 704(c) and vice versa, provided there is no tax avoidance potential.[3]

The bill also eliminates a special rule for the treatment of contributions of undivided interests in property to a partnership by the various owners of the undivided interest. This rule, which allowed the partnership to treat the property as if it had not been contributed to the partnership, is made unnecessary by the provision of the bill requiring allocations of depreciation, depletion, and gain or loss to reflect the difference between the basis of property and its fair market value at the time of contribution.

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[2] Generally, the fair market value of contributed property will be determined by the arm's-length dealings of the various partners as reflected in their capital accounts and will not be upset by the Treasury except in cases of abuse.

[3] In addition, it may be appropriate to amend example (2) of Treas. Reg. sec. 1.704-1(c) to provide that if the property there is sold for a price exceeding $9,000, the gain represented by the first $200 of such excess would be allocated to partner C.

The bill also makes two conforming amendments in sections 613A(c)(7)(D) (relating to percentage depletion) and 743(b) (relating to optional adjustment to basis).

Effective Date

The provision is effective with respect to property contributed to a partnership after March 31, 1984, in taxable years ending after that date.

Revenue Effect

This provision will increase fiscal years budget receipts by $4 million in 1984, $61 million in 1985, $147 million in 1986, $178 million in 1987, $240 million in 1988, and $298 million in 1989.

2. Retroactive Allocations (sec. 72 of the bill and sec. 706 of the Code)

Present Law

General rules

The Tax Reform Act of 1976 amended the partnership provisions to preclude a partner who acquires his interest late in the taxable year from deducting partnership expenses incurred prior to his entry into the partnership (so-called "retroactive allocations" of partnership losses). The 1976 Act provided that when partners' interests change during the taxable year, each partner's share of various items of partnership income gain, loss, deduction and credit is to be determined by taking into account each partner's varying interest in the partnership during the taxable year.

Present law allows two basic methods for determining the amount of a partnership's income, gain, loss, deduction, and credit which may be allocated to a partner entering during the taxable year. The first method provides for an "interim closing" of the partnership books whenever a new partner enters the partnership. This method traces partnership income, gain, loss, deduction, and credit to the particular segment of the partnership taxable year during which it is incurred. For example, a partner admitted on December 1 to a partnership using a calendar taxable year could be allocated only his share of items incurred by the partnership during the month of December.

The second method allowed by present law provides for a proration of partnership income, gain, loss, deduction, and credit for the entire taxable year. This proration is generally based on the number of days in the partnership taxable year during which the entering partner was a member of the partnership divided by the total number of days in the partnership taxable year. The entering partner's share of each partnership item for the taxable year is determined by multiplying this fraction by the amount of partnership income, gain, loss, deduction, and credit that the partner would have been allocated had he been a partner for the entire partnership taxable year. For example, a partner admitted on December 1 to a partnership having a calendar year taxable year would be allocated 1/12 of his hypothetical share of items for the entire partnership taxable year, regardless of the point during the year at which these expenses were incurred.

To avoid undue complexity, present law generally permits use of a convention (for both the interim closing and proration method) under which partners are treated as entering on a semi-monthly basis. That is, partners entering in the first half of a month can all be treated as entering on the first day of the month and partners entering in the last half of the month can be treated as entering on the 16th day of the month.

Techniques for avoiding retroactive allocation rules

Tiered arrangements

Some taxpayers have attempted to avoid the retroactive allocation rules by use of tiered partnership arrangements combined with the interim closing method of allocations. For example, assume that Parent partnership owns a 90 percent interest in Subsidiary partnership and that both Parent and Subsidiary use calendar year taxable year. Assume further that Subsidiary has a $10,000 loss for the calendar year 1983, and that Parent's distributive share is $9,000. If Partner A buys an 80-percent interest in Parent at the close of business on December 31, 1983, Parent may make an interim closing of its books on December 30, 1983, in order to determine A's distributive share of partnership items. Parent may take the position that, for tax purposes, it incurs its entire $9,000 portion of Subsidiary's loss on December 31, 1983, i.e., at the close of Subsidiary's taxable year, regardless of when the loss was actually incurred by subsidiary. Partner A will, therefore, claim a $7,200 loss on his 1983 return (Parent's $9,000 loss multiplied by his 80-percent interest in the partnership on December 31, 1983) rather than the $19.73 that he would be entitled to under a proportioned share computation (i.e., $9,000 x 80% x 1/365 days).

The Internal Revenue Service has taken the position that, in the situation above, losses are sustained by the parent partnership in this case at the same time they are sustained by the subsidiary partnership and that the limitation against retroactive allocations is equally applicable in this situation. Rev. Rul. 77-311, 1977-2 C.B. 218. However, taxpayers may continue to take a contrary position on their returns.

Cash basis partnerships

In addition to tiered arrangements, partnerships may attempt to avoid the retroactive allocation rules by using the cash method of accounting and deferring actual payment of deductible items until near the close of the partnership's taxable year. For example, if a partnership defers the payment of an expense (e.g., interest) until December 31, and the partnership uses the interim closing method of allocations, a partner admitted on December 31 may be allowed a deduction for a full portion of the expense. This may be the case although the expense has economically accrued at an equal rate throughout the taxable year.

Reasons for Change

The 1976 rules were enacted to clarify that the law required the inclusion of income and loss according to a partner's varying interests during the taxable year. Legislative history indicates that Congress, in adding these rules, intended to prevent partners investing in a partnership toward the close of the taxable year from deducting expenses which were incurred prior to their entry into the partnership.[4] In adding these rules, Congress rejected the argument that retroactive allocations were proper because the funds invested by the new partners served to reimburse the original partners for their expenditures so that, as an economic matter, the new partners had incurred the costs for which they were claiming deductions. This argument was found unpersuasive when the new partner was compared with an investor directly purchasing property which had generated tax losses earlier in the taxable year; that investor would clearly not be entitled to deduct the losses incurred prior to his ownership of the property.

The committee believes that the policy of the 1976 act prohibiting retroactive allocations and the rationale for that policy remain equally applicable today. Taxpayers should not be able to attempt to avoid the 1976 rules through the use of tiered or other arrangements.

The committee recognizes that the use of cash method partnerships raises issues distinct from tiered arrangements and that the cash method may be appropriate for partnerships in certain circumstances. However, the committee believes that the cash method should not be used to create deductions for late-entering partners. Accordingly, the bill requires that cash basis items generally be prorated over those days during the year to which they are economically attributable and that each partner take into account only that portion of each item attributable to that portion of the year for which he is a partner. This rule will prevent abuses associated with retroactive allocations without causing undue hardship or administrative burdens to cash basis partnership. To prevent undue burdens, the bill provides that Treasury regulations may provide reasonable procedures for complying with the daily proration rule.

Explanation of Provision

General rule

The bill provides a general rule comparable to the present rule that if any partner's interest in a partnership changes at any time during the partnership's taxable year, each partner's share of any item of partnership income, gain, loss, deduction, or credit is to be determined by using any method prescribed by Treasury regulations which takes into account the varying interests of the partners in the partnership during the taxable year. It is anticipated that these regulations will apply the law in a manner consistent with the policies of the Tax Reform Act of 1976 and of the new provisions.

Cash basis partnership

With respect to partnerships using the cash method of accounting, the bill provides new rules for the allocation of items among partners when there is a change in partnership interests. First, for specified cash basis items, the bill requires that the item be assigned to each day in the period to which it is attributable. The amounts so assigned are then apportioned among the partners in proportion to their interest in the partnership at the close of each day. These rules (which apply except when regulations otherwise provide) effectively require, for purposes of determining the partners' varying interests in a partnership taxable year, that certain items be allocated under the accrual method. The items to which the provision applies are (1) interest, (2) taxes, (3) payment for services or for the use of property, and (4) any other item of a kind specified in Treasury regulations as an item with respect to which the rule is necessary to avoid retroactive allocations to the partners.

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[4] H. Rep. 94-658, accompanying H.R. 10612, 94th Cong. 1st Sess, P. 124 (November 12, 1975); S. Rep. 94-938, 94th Cong., 2d Sess. p. 97 (June 10, 1976).

For example, if a new partner joins a calendar-year partnership on December 1, and if the partnership on December 1 pays an interest expense which has accrued over the course of the entire year, the partner would be entitled to 1/12 of his otherwise allocable share of deduction for that item. If the expense were attributable only to the final 6-months of the year, he would receive 1/6 of his otherwise allocable share of that item. The committee intends that the determination of the period to which an expense is attributable will be made in accordance with economic accrual principles.

The bill provides that when application of the economic accrual principles described above would result in allocating an item to periods before or after the current taxable year, those items are to be allocated entirely to the first in the case of items allocable to prior years and entirely to the last day of the year in the case of items allocable to future periods. This rule does not make any substantive change to the timing of any deduction under present law; rather, it merely describes the treatment of amounts that are currently deductible even though allocable to a past or future year in economic terms. For example, if a cash method partnership failed to pay for services provided to it in year 1 until the middle of year 2, the amount of the year 2 deduction would be allocated to the first day of year 2. Similarly, if the partnership was required to pay property taxes in year 1 for the last half of year 1 and the first half of year 2, the amount allocable to year 2 would be treated as paid on the last day of year 1. Of course, this latter rule will have limited application due to the limitations on the deductibility of prepaid expenses.

Tiered partnerships

The bill provides that, if a parent partnership holds an interest in a subsidiary partnership, then (except to the extent provided by regulations) the parent, partnerships share of any item of income, gain, loss, deduction, or credit of the subsidiary partnership is to be prorated equally over that portion of the taxable year during which the parent partnership had an interest in the subsidiary. For example, if a new partner who has a 25-percent interest in all partnership items enters a parent partnership that is on a calendar taxable year on December 1, and the parent has had a 50-percent interest in a calendar year subsidiary partnership for the subsidiary's entire year, then that partner would be allocated 1/96th of the subsidiary's items for the taxable year (regardless of when each item was actually incurred). (That is his 1/4th share of 1/12th of the parent's 1/2 of the items of an entire year.) If the parent had an interest in the subsidiary beginning July 1, the partner would be allocated 1/192nd of each of the subsidiary's items. (That is his 1/4 share of 1/12th of parent's 1/2 of the items for 1/2 of the year.) These rules are intended to prevent the use of tiered partnership to avoid the retroactive allocation rules.

Other rules

The bill provides that the daily apportionment rule will apply except to the extent provided by Treasury regulations. In this connection, the committee recognizes that most partnerships do not account for the admission of new partners on a daily basis and that daily apportionment of partnership income and expenses would thus result in an undue administrative burden. Accordingly, to prevent undue complexity, it is anticipated that the regulations will provide, in part, that a partnership has complied with the daily proration of the statute even though it operates under the semimonthly convention described under present law, above.

The committee does not intend that any inference be drawn regarding the present law treatment of either the tiered partnership or cash methods arrangement for allowing retroactive allocations.

Effective Dates

The rule regarding tiered partnerships is effective for amounts paid or accrued after March 31, 1984. The rule regarding cash basis partnerships is effective for amounts attributable to periods after March 31, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $50 million in 1985, $75 million in 1986, $100 million in 1987, $100 million in 1988, and $100 million in 1989.

3. Payments to Partners for Property or Certain Services (sec. 73 of the bill and secs. 707 and 709 of the Code)

Present Law

General background

The contribution of property to a partnership in return for a partnership interest is generally a tax-free transaction (sec. 721). If, instead of contributing property to a partnership, the taxpayer sells property to the partnership, the taxpayer realizes income to the extent of gain on the sale and the partnership is generally required to capitalize the amount of the purchase price, which may be deductible over the useful life of the property (or any applicable accelerated recovery period). When services are provided to a partnership, the partnership may generally deduct amounts paid or incurred for such services unless such expenses are required to be capitalized) and the party providing services must include an equivalent amount in income. This rule also applies to services provided by a partner acting in a capacity other than that of a member of the partnership.

When a partnership allocates income from partnership operations among its partners, the partners generally include these amounts in income in the year taxable to the partnership. This is distinct from a distribution of partnership assets, which is generally tax-free to the extent that the amount distributed does not exceed the recipient partner's basis for his partnership interest. This tax-free treatment is based, in part, on the theory that a partner is entitled to withdraw his investment in a partnership before recognizing gain on the investment.

Although amounts allocated to a partner are not deductible by the partnership, an allocation of taxable income to one partner may have the effect of a deduction for the remaining partners by reducing the amount of taxable income allocated to them.

Avoidance of capitalization requirement for payments for property or services

A partnership, like any taxpayer, is generally required to capitalize (rather than currently deduct) expenditures which relate to the improvement of property or which create an asset the useful life of which extends substantially beyond the end of the taxable year. Present law (sec. 709) provides specifically that a partnership may not currently deduct amounts paid or incurred to organize the partnership. Instead, the partnership is permitted an election to deduct these amounts ratably over a 5-year period. Alternatively, the partnership may capitalize these expenses. The denial of current deductions for organizational expenses was made explicit by the Tax Reform Act of 1976. In addition, neither the partnership nor any partner is ever permitted to deduct partnerships syndication expenses.

If the organizer or syndicator of a partnership is also a general partner of the partnership, allocations of partnership gross or net income to the organizer and related distributions to him in payment for his services, if recognized, could have the effect of a current deduction for organizational and syndication fees despite the rules above. This results because the allocation, which in this case when coupled with an equivalent distribution is economically indistinguishable from a direct payment, reduces the taxable income allocated to the remaining partners in the year of the allocation. The capitalization requirement for other types of capital expenditures can also be avoided by this type of arrangement.

Present law (sec. 707) provides that, if amounts are paid or payable to a partner when he engages in a transaction with the partnership in a capacity other than as a member of the partnership, or if guaranteed payments are made to a partner for services or use of capital capitalization is required to the same extent as with comparable payments to a non-partner. This rule prevent the use of partnership allocations to pay for goods and services under certain conditions. The courts, however, have held that payments based on partnership gross income generally are not to be regarded as guaranteed payments for purposes of this provision. *Pratt v. Commissioner,* 64 T.C. 203 (1975), *aff'd,* 550 F. 2d 1023 (5th Cir. 1977).

Disguised sales

Gain or loss is generally not recognized on the contribution of property to a partnership in return for a partnership interest (sec. 721). Additionally, distributions of money from a partnership to a partner are generally tax-free to the extent of the adjusted basis of the recipient partner's interest in the partnership (sec. 731). However, the partner is required to reduce the basis of his partnership interest by the amount of money received (thereby deferring tax until he disposes of the interest).

Treasury regulations provide that, if the transfer of property by a partner to a partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange rather than a contribution (Treas. Reg. sec. 1.721-1(a)). Based on these regulations, the Internal Revenue Service has argued that a contribution of cash by one partner followed by a distribution of cash to another partner should be recharacterized as a sale. These regulations state that the substance of the transaction, rather than its form, will govern in such cases. Treasury regulations also provide that if a contribution of property is made to a partnership and (1) within a short time before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or (2) within a short time after such contribution to the partnership, contributed property is distributed to another partner, tax-free distribution treatment may not apply. These regulations further state that tax-free treatment does not apply if, a purported distribution was, in fact, made to effect an exchange of property between two or more of the partners or between the partnership and a partner (Treas. Reg. sec. 1.731-1(c)(3)).

The rules above do not always prevent de facto sales of property to a partnership or another partner from being structured as a contribution to the partership, followed (or preceded) by a tax-free distribution from, the partnership. For example, under the case law, partner A may contribute $50,000 in cash to a partnership and partner B may contribute property with a basis of $50,000 and a fair market value of $100,000. If the partnership then transfers $50,000 in cash to partner B, partner B may claim that this $50,000 represents a distribution not exceeding his basis in the partnership and for which he is therefore not subject to tax. (The basis for partner B's interest in the partnership would then be reduced from $50,000 to $0.) If this result is permitted, partner B has deferred or avoided tax on a transaction which closely resembles a sale of property to the partnership (or a partial sale to partner A followed by a joint contribution). Case law has permitted this result, despite the regulations described above, in cases which are economically indistinguishable from a sale of all or part of the property. *See, Otey v. Commissioner,* 70 T.C. 312 (1978), *aff'd per curiam* 634 F. 2d 1046 (1980); *Communications Satellite Corp.* v. *United States* 223 Ct. Cl. 253 (1980); *Jupiter Corp.* v. *United States*, No. 83-842 (Ct. Cl. 1983).

Reasons for Change

The committee is concerned that partnerships have been used to effectively circumvent the requirement to capitalize certain expenses by making allocations of income corresponding distributions in place of direct payments for property or services. The committee believes that these transactions must be expressly prohibited if the integrity of the capitalization requirements of present law is to be preserved. For example, in *Ellison* v. *Commissioner,* 80 T.C. 391 (1983), the Tax Court rejected use of a similar technique to convert purchase price into the equivalent of a deductible expense and concluded that a retained income interest in the seller of property was in reality a disguised purchase price.

In the case of disguised sales, the committee is concerned that individuals have deferred or avoided tax on sales of property by characterizing sales as contributions of property followed (or preceded) by a related tax-free partnership distribution. Although Treasury regulations provide that the substance of the transaction should govern, court decisions have allowed tax-free treatment in cases which are economically indistinguishable from sales of property to a partnership. The committee believes that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance.

Explanation of Provisions

Recharacterization of payments for capital expenses

If a partner performs services for, or transfers property to, a partnership, and receives a related allocation (direct or indirect) of partnership income or gain, the transaction will be treated as a transaction between the partnership and a person who is not a partner, if a direct payment for the property or services would have been a capital expenditure by the partnership. Thus, the amount paid to the partner in consideration for the property or services will be treated as a fee for services or purchase price of property provided to the partnership (as the case may be), and the partnership will be required to capitalize these amounts. The partnership will disregard the purported allocation to the partner performing services or transferring property to the partnership in determining the partners' shares taxable income or loss under the partnership agreement and section 704(b).

For purposes of the rule, expenses required to be capitalized include syndication expenses and organization expenses. When allocations are made with respect to organization expenses the taxpayer will be considered to have foregone the right to amortize rather than capitalize such expenses.

The committee does not intend that this provision will apply in every instance in which a partner acquires an interest in a partnership and also performs services or transfers property to the partnership. In particular, the committee does not intend to repeal the general rule under which gain or loss is not recognized on a contribution of property in return for a partnership interest (sec. 721) or to apply this new provision in cases in which a partner receives an allocation (or an increased allocation) for an extended period to reflect his contribution of property or services, payment for which must be capitalized, to the partnership provided the allocation is not fixed or determinable. However, the committee does intend that the provision apply to allocations which are determined to be related to the performance of services (payments for which must be capitalized), or the transfer of property to, the partnership and which have the substantive economic effect of direct payments for such property or services.

The bill authorizes the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the provision. In prescribing these regulations, the Treasury should be mindful that the committee is concerned with transactions that work to avoid capitalization requirements and not with non-abusive allocations that reflect the various economic contributions of the partners. These regulations may apply the provision both to one-time transactions and to continuing arrangements which utilize purported partnership allocations and distributions in place of capital payments. These regulations may provide, where appropriate, that the service performer is not a partner of the partnership or simply not performing services in his capacity as a partner. Continuing arrangements that could be appropriately covered include annual compensation arrangements in which income allocations and property distributions are fixed in amount or reasonably determinable under all the facts and circumstances and which arise in connection with services direct payments for which must be capitalized. These allocations may be either "capped" allocations of partnership income (i.e., percentage allocations subject to an annual maximum amount where the parties could reasonably expect the cap to apply in most years) or allocations for a fixed number of years under which the income that will go to the partner is reasonably certain. In the case of continuing arrangements, the time at which income will be allocated to the partner may be a factor indicating that an allocation is related to a properly capitalized expense. For example, an allocation close in time to the performance of services, or the transfer of property, is more likely to be related to the services or property. Also, when the income subject to allocation arises over an extended period or is removed from the services or property contributed by a partner, the differences between capitalization and use of an allocation are reduced. The committee specifically intends that the provision will apply to allocations used to pay partnership organization or syndication fees subject to the general principles above.

In the case of allocations which are only partly determined to be related to the performance of services for, or the transfer of property to, the partnership, the provision will apply to that portion of the allocated which is reasonably determined to be related to the property or services provided to the partnership. Finally, it is anticipated that Treasury regulations will provide for the coordination of this provision with the existing rules regarding payments to partners in their non-partner capacity (sec. 707(a)), guaranteed payments to partners (sec. 707(c)), sales or exchanges with respect to controlled partnerships (sec. 707(b)), certain other payments to partners (sec. 736 and related provisions), consistently with the principles above.

The committee does not intend to create any inference regarding the tax treatment of these transactions under existing law.

Disguised sales

The bill provides that, when a partner transfers money or other property to a partnership and there is a related direct or indirect transfer of money or other property to that partner or other partner, the transaction is to be treated (as appropriate) as a sale between the partners of property (including partnership interests) or as a partial sale and partial contribution of the property to the partnerships. The selling partner will be required to recognize gain (or loss) on all or part of the amount received in the transaction. This rule is intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership thereby deferring or avoiding tax on the transaction.

To accomplish this, the bill authorizes the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this provision. In prescribing these regulations, the Treasury should be mindful that the committee is concerned with transactions that attempt to disguise a sale of property and not with non-abusive transactions that reflect the various economic contributions of the partners. Thus, it is anticipated that the regulations will apply the provision when the transfer of money or property from the partnership to the partner is related to the transfer of money or other property to the partnership in such manner that, taking into account all the facts and circumstances, the transaction substantially resembles a sale or exchange of all or part of the property including on interest in the partnership) to the or another partner or a sale or exchange of all or part of the property to the partnership. For example, when a partner contributes appreciated property to a partnership and receives a distribution of money or property within a reasonable period before or after such contribution, that is approximately equal in value to the portion of contributed property given up, the transaction will be treated as a sale or exchange of property. This result will also apply to the extent (1) the transferor partner receives the proceeds of a loan related to the property while responsibility for repayment of which rests with the partnership or the other partners, or (2) the partner has received a loan related to the property in anticipation of the transaction and responsibility for repayment of the loan is transferred to the other partners. Although the rule applies to sales of property to the partnership, the committee does not intend to prohibit a partner from receiving a partnership interest in return for contributing property which entitles him to priorities or preferences as to distributions from operations that are not directly related to his contribution. The committee anticipates that the Treasury regulations will treat transactions to which the provision applies as a sale of property or partnership interests among the partners or as a partial sale and partial contribution of the property to the partnership, with attendant tax consequences, depending upon the underlying economic substance of the transaction. Finally, it is anticipated that the regulations will take into account the effect of liabilities which may accompany effective sales of property to a partnership or other partner.

No inference regarding the tax treatment of contribution arrangements or any similar transactions under existing law should be drawn from the committee's action.

Definition of partner

For purpose of the provisions regarding payments for capital expenses, and disguised sales, the bill provides that persons who become partners after performing services for, or transferring property to, the partnership are to be treated as partners.

Effective Dates

The provision regarding is effective for services performed or property transferred after March 1, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $20 million in 1985, $51 million in 1986, $60 million in 1987, $69 million in 1988, and $78 million in 1989.

4. Character of Gain or Loss on Disposition of Contributed Property (sec. 74 of the bill and new sec. 724 of the Code)

Present Law

Character of gain or loss.—The character of income or loss from the disposition of property by a partnership is generally determined at the partnership level.

Under present law, a contribution of property to a partnership by a partner, followed by a sale of the property, may result in a character of gain or loss different from that which would have resulted from a direct sale by the partner. Thus, ordinary income may be converted into capital gain when dealer status exists at the partner but not at the partnership level. For example, a taxpayer having appreciated inventory may convert the gain on such property from ordinary income to capital gains by contributing the inventory property to a partnership and having the partnership sell the property. Conversely, a capital loss may be converted into an ordinary loss when dealer status exists at the partnership but not the partner level. For example, a taxpayer owning securities which have declined in value may attempt to convert his capital losses into ordinary losses by contributing the securities to a dealer partnership and claiming that the loss upon a later sale of the securities was incurred in the ordinary course of the partnership's trade or business.

This result can be contrasted with the treatment of property distributed by a partnership and subsequently sold by the recipient. The character of gain or loss on property in such a case generally is determined by the character of the property in the hands of the distributee with two exceptions. First, in the case of certain inventory items, the ordinary income character of an asset in the hands of the partnership carries over to the partner for a 5-year period. Second, the ordinary income character of certain unrealized trade or business receivables also carries over to the partner on an indefinite basis (sec. 735).

Reasons for Change

The committee is concerned that, under certain circumstances, a taxpayer may alter the character of gain or loss merely by contributing property to a new or existing partnership. In particular, the conversion of capital to ordinary losses by contributing securities to a dealer partnership may allow a taxpayer to receive the benefits of capital gain taxation on appreciated securities while deducting ordinary losses on those which have declined in value. The committee believes that these potential abuses should be prevented by preserving the pre-contribution character of contributed (or substitute basis) property for an appropriate period.

For similar reasons, the committee believes the existing rules preserving the character of certain property distributed by a partnership should apply to property the basis of which is determined by reference to the distributed property.

Explanation of Provision

Under the bill, if a partnership disposes of property which was inventory property in the hands of the partner immediately before such contribution within 5 years after its contribution by a partner, any gain or loss recognized by the partnership on the disposition will be treated as ordinary income or loss. Thus, gains or losses on such items will retain their ordinary character for 5 years after the date of contribution. Gain or loss on the sale of unrealized receivables contributed by a partner would be treated as ordinary income or loss regardless of the date of disposition. These rules mirror the present law treatment of unrealized receivables and inventory distributed to a partner by a partnership. The bill also provides that built-in losses on capital assets will retain their character as capital losses for 5 years after the date of contribution, but only to the extent of pre-contribution unrealized losses.

To prevent avoidance of the rules requiring a carryover of the character of contributed property by exchanging items of property, the rules also apply to any property the basis of which is determined by reference to the basis of contributed property.

Specifically, if contributed property subject to the rule is transferred to another person in a nonrecognition transaction and the transferee holds the property at a basis determined by reference to the transferor-partnership's basis, the transferee will be subject to the same characterization rules. Similarly, if the partnership exchanges the contributed property for other property which it holds with a basis determined by reference to the contributed property that was exchanged, the characterization rules will apply to the property received in the exchange. Similar basis tainting rules are added to the existing provision regarding certain ordinary income property distributed by a partnership to a partner (sec. 735). It is intended that the basis tainting rules regarding contributed and distributed property will apply only for the period during which the underlying rules would apply if the property were not disposed of in a nonrecognition transaction. For example, if capital loss property were contributed to a partnership and subsequently disposed of in a nonrecognition transaction, capital loss treatment would apply to any substitute basis property only for the duration of the 5-year period beginning on the date of the original contribution.

The bill further provides that, for purposes of the rules regarding contributed and distributed property (i.e., the new rules and sec. 735 but not sec. 751), certain property which would qualify as a capital asset if held for one year or more by the partner or partnership prior to contribution or distribution (as the case may be) will not be treated as ordinary income property. This change prevents property which would have qualified for capital gain treatment if held by its original owner from receiving less favorable treatment following the transfer of the property.

Effective Date

The provisions regarding contributed property apply to property contributed to a partnership after March 31, 1984, in taxable years ending after that date.

The amendments to the provisions regarding property distributed by a partnership apply to property distributed after March 31, 1984, in taxable years ending after that date.

Revenue Effect

This provision will increase fiscal year budget receipts by $24 million in 1985, $63 million in 1986, $66 million in 1987, $67 million in 1988, and $69 million in 1989.

5. Transfers of Partnership Interests by Corporations (sec. 75 of the bill and new sec. 744 of the Code)

Present Law

The gain or loss on the sale or exchange of a partnership interest in generally a capital gain or loss. However, money or property received by a transferor partner in exchange for all or part of his partnership interest is subject to ordinary income treatment to the extent it is attributable to certain ordinary income assets of the partnership (sec. 751). For purposes of this provision, ordinary income items include the recapture of depreciation deductions previously taken on partnership property.

Also under present law, when a corporation distributes property (or sells property in the course of certain complete liquidations), income attributable to recapture property (and installment sales) is taxed to the corporation, while nonrecapture gain attributable to appreciation in value of the transferred property generally goes unrecognized.

Some taxpayers have taken the position that the present law recapture provisions do not apply to the distribution or liquidating sale by a corporation of an interest in a partnership that holds recapture property. According to this interpretation, a corporation may avoid recapture by contributing recapture property to a partnership and distributing interests in the partnership to its shareholders, or selling the interests in the course of liquidation. Since the partnership interests themselves arguably do not constitute recapture property, the corporation may claim that no gain should be recognized on the transaction.

Basis adjustment.—Under present law (secs. 743 and 754), a partnership may elect to adjust the basis of partnership assets to offset gain or loss recognized by its partners on a sale or exchange of interests in the partnership. The election must apply to all sales or exchanges of partnership interests and may be revoked only for sufficient reason (Treas. Reg. sec. 1.754-1(c)).

Reasons for Change

The existing corporate recapture rule is intended to insure that corporate income is recognized on a distribution of recapture property to a corporations' shareholders or upon a liquidating sale of such property. Similarly, the requirement that a taxpayer recognize ordinary income on sales or exchanges of certain partnership interests prevents taxpayers from avoiding ordinary income taxation by transferring interests in partnership which hold assets that would be subject to depreciation recapture (or otherwise subject to ordinary income treatment) if the assets themselves were disposed of.

If an interest in a partnership which holds recapture property may be distributed, or sold in liquidation, without being subjected to recapture, the corporation has effectively avoided the recapture taxes. Thus, if this analysis is correct, the corporation may have benefitted from the tax advantages of depreciation (including accelerated depreciation) without being subject to recapture as would the case if the corporation distributed the recapture property directly to its shareholders. The committee believes that the Code should specifically prohibit this unintended tax benefit. To accomplish this, the bill generally requires that the distribution of the partnership interest be treated as if the corporation had made a direct distribution (or liquidating sale) of the recapture and other recognition assets.

Explanation of Provision

For purposes of determining the amount of gain recognized by a corporation on any distribution, the bill treats the distribution of a partnership interest as a distribution of the corporation's proportionate share of the recognition property of the partnership. Recognition property is defined as any property with respect to which the corporation would recognize gain if it distributed the property in a distribution (sec. 311 or 336) or sold the property in a liquidation sale (sec. 337). The corporation's proportionate share of recognition property shall be determined in accordance with the principles of section 751. In determining the amount of gain recognized on the transaction, the corporation is treated as if it had made a direct distribution (or liquidating sale or exchange) of the underlying recognition property.

The bill specifies that the amount of gain recognized by a corporation under the rules above may not be greater than the amount of gain that would have been recognized if the partnership interest had been sold directly by the corporation. This limitation would be applied separately to the various gains arising under section 751 without reduction for any separate losses. For, example if application of section 751 to a sale of the partnership interest would result in $200 of gain and $100 of loss, the limitation would be $200.

The bill provides that, in determining whether property of a partnership is recognition property, the partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner. This rule is intended to prevent the avoidance of the rules above by the use of tiered or multitiered partnership arrangements. (See item E.6. below).

The bill further provides that, under Treasury regulations, rules similar to the rules above shall apply in the case of interests in trusts. These rules will prevent the use of interests in trusts to achieve results similar to those prevented by the statute in the case of partnership interests.

No inference should be drawn from the committee's action regarding the treatment of these transactions under present law.

Basis adjustments.—When a partnership has an appropriate election in effect, the basis of partnership property may be adjusted following the taxable sale or exchange of interests in the partnership to reflect gain or loss on the transfer (secs. 743 and 754). The bill clarifies that the basis of partnership property is to be adjusted to take into account amounts recognized on transfers accomplished through distributions (whether by corporations or partnerships).

Effective Date

The provision applies to distributions, sales,and exchanges made after March 1, 1984, in taxable years ending after that date.

Revenue Effect

This provision will increase fiscal year budget receipts by $50 million annually for years 1986 through 1989.

6. Abuses Involving Tiered Partnerships (secs. 76 and 78 of the bill and secs. 734, 751, and 754 of the Code)

a. Use of tiered partnerships to alter character of income on exchanges of partnership interest

Present Law

The gain or loss on the sale or exchange of a partnership interest is generally a capital gain or loss. However, money or property received by a transferor partner in exchange for all or part of his partnership interest is subject to ordinary income treatment to the extent it is attributable to certain ordinary income assets of the partnership (sec. 751). These items include (1) certain unrealized receivables of the partnership, and (2) inventory items of the partnership which have attributed substantially in value. Generally, substantially appreciated inventory is defined as inventory having a fair market value greater than 120 percent of the partnership's adjusted basis for the property and greater than 10 percent of the fair market value of all partnership property, other than money. Unrealized receivables of a partnership include rights to payments that have not yet been taken into account under the partnership method of accounting and a variety of recapture amounts with respect to partnership property. Ordinary income treatment also applies to distributions to a partner that have the effect of causing a shifting of the various partners' interests in unrealized receivables or substantially appreciated appreciated inventory of the partnership property. These rules prevent a partner from receiving capital gain treatment for gains attributable to ordinary income property of the partnership.

Under present law, some taxpayers have argued that ordinary income treatment of unrealized receivables and substantially appreciated inventory may be avoided when the assets are held in a second partnership. When this occurs, it is not clear whether the ordinary income rules of section 751 should be applied by regarding change in interests in the first partnership as an exchange of a capital asset (the interest in the second partnership) or of ordinary income assets (the assets owned through the second partnership).

Reasons for Change

The committee believes that taxpayers should not be allowed to convert potential ordinary income into capital gains by selling their partnership interests. This policy has been reflected in the 1954 Code since the enactment. The committee knows of no reason why the use of tiered partnership arrangements should be permitted to frustrate this policy.

Explanation of Provision

Under the bill, the ordinary income rules of section 751 will be applied by regarding income rights, as section 751 does under present law, as severable from the partnership interest.[5] Under this approach, a partner will be treated as disposing of such items independently of the rest of his partnership interest. The rule will apply regardless of how many tiers of partnerships exist between the transferring or distributee partner and the ordinary income assets.

The committee amendment also provides that this approach regarding income rights as severable is to apply to interests in trusts held by partnerships in the manner provided for in regulations.

Effective Date

The provision is effective for distributions, sales, and exchanges made after March 31, 1984, in taxable years ending after that date.

Revenue Effect

This provision has a negligible effect on fiscal year budget receipts.

b. Use of tiered partnership to achieve step-up in basis of partnership assets

Present Law

The partnership provisions of present law were generally designed to permit partners to enter and leave a partnership without recognizing gain or loss. To prevent the general rules from allowing a partner to escape tax on gain or from extinguishing a loss that a partner would otherwise be entitled to, the Code provided for a variety of rules relating to basis of the the partners' interests in the partnership, and in contributed or distributed property and to the partnership's basis in partnership property. In certain transactions, a partner may experience an increase or decrease in basis that is not reflected appropriately in the basis of other assets. For example, if a partnership distributes property which it holds at a basis of $900 to a partner with an interest with a $500 basis, the Code will not permit the $900 basis to carry over but will instead require a substitution of the $500 basis. Thus, $400 of basis is potentially "lost."

Present law permits, but does not require, a partnership in such a case to elect to adjust the basis of remaining partnership assets. A similar result applies in the case of transfers of interests in the partnership (sec. 743). The election to step up (or step down) may be revoked only upon a showing of sufficient reason and applies to all distributions by a partnership and to all transfers of interests in the partnership.

Since the election may at some future date require a decrease in basis, partnerships may not make the election where it appears at first to be advantageous. Under present law, it may be possible in a tiered partnership arrangement to manipulate the basis adjustment rules and the election to adjust basis in such a manner as to effectively distribute high basis property to a low basis partner without causing him to recognize gain when the property is sold. For example, assume that partnership AB holds two assets, asset 1 with a basis of 0 and a fair market value of $100 and asset 2 with a basis of $100 and a fair market value of $100. A distribution of asset 2 to partner A, who has a zero basis for his interest, would result in A holding the asset at a zero basis, and the basis of asset 1 will be increased to $100, assuming that the partnership has a section 754 election in effect. Thus, if asset 1 is sold, no gain or loss will be realized, but if asset 2 is sold, A will realize $100 gain. However, if asset 2 is instead contributed to a second partnership in which partnership AB has a major interest (e.g., 99 percent), its basis will remain at $100. A distribution of AB's interest in the second partnership to partner A will result in the basis of the interest being reduced to zero but (if the second partnership does not have section 754 election in effect) the basis of asset 2 will remain $100. Thus, the effect is an increase in total basis of assets so that, in this example, both asset 1 and asset 2 can subsequently be sold without recognition of gain. While the basis of A's interest in the second partnership would be reduced by $100, this would not have any effect so long as A retains his interest in the partnership. A could cause asset 1 to be sold and reinvest the proceeds through the second partnership without recognizing any gain. Taxpayers may also attempt to create more complex arrangements to achieve results similar to the results described above.

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[5] See H.R. Rep. No. 1337, 83rd Cong. 2nd Sess. pages 70, 71 (March 9, 1954).

Reasons for Change

The committee believes that it is inappropriate for taxpayers to defer or avoid taxation by using inconsistent basis adjustment elections for related partnerships.

Explanation of Provision

The bill prohibits a partnership from adjusting the basis for its interest in another partnership following a distribution if the second partnership does not have a section 754 election in effect. This provision is intended to prevent taxpayers from achieving a net step-up in the basis of assets by means of inconsistent elections under section 754. This occurs because under section 743 a distribution of a partnership interest is treated as a distribution of the underlying assets (see item E.5., above).

Effective Date

This provision is effective for distributions after March 1, 1983, in taxable years ending after that date.

Revenue Effect

This provision has a negligible effect on fiscal year budget receipts.

7. Exchanges of Like-Kind Property (sec. 77 of the bill and sec. 1031 of the Code)

Present Law

General rules

An exchange, like a sale of property, is generally a taxable transaction. However, present law provides that no gain or loss is to be recognized if property held for productive use is the taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that is also to be held for productive use in a trade or business or for investment. This provision (sec. 1031) specifically does not apply to exchanges of stock in trade or other property held primarily for sale, or to stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest.[6]

The nonrecognition of gain in like-kind exchange applies only to the extent that like-kind property is received in the transaction. For example, if a taxpayer holding a parcel of land having a basis of $50,000 and a fair market value of $100,000 exchanges the property for a parcel of land worth $90,000 plus $10,000 in cash, the taxpayer would recognize $10,000 of gain on the transaction. The remaining $40,000 of gain would be deferred until the taxpayer disposes of the second parcel as a taxable sale or exchange. No losses may be recognized from a qualifying like-kind exchange.

Present law does not require specifically that a like-kind exchange be completed within a specified period in order to qualify for tax-free treatment. In *Starker* v. *United States*, 602 F.2d 1341 (9th Cir. 1979), the United States Court of Appeals for the Ninth Circuit held that an exchange qualified for like-kind treatment although the property to be exchanged could be designated by the transferor for up to 5 years after the transaction and although the transferor could have ultimately received cash rather than like-kind property. The case involved an exchange of real property in which the transferor eventually received like-kind property.

Installment sales.—The Internal Revenue Code provides special rules for the reporting of income from installment sales (sec. 453). These rules allow gains from an installment sale to be spread out over the period during which installment payments are received. In general, the taxpayer reports income in each year for that proportion of the payments received during the year which is equivalent to the ratio which the gross profit from the sale bears to the total contract price. An installment sale is defined as a disposition of property where at least one payment is received after the close of the taxable year in which the disposition occurs. For this purpose, payment includes property permitted to be received without the recognition of gain (sec. 453(f)(6)).

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[6] Special rules allow tax-free like-kind exchanges of stock of the same corporation (sec. 1035), certain insurance policies (sec. 1036), and certain U.S. obligations (sec. 1037). Additionally, the law provides for nonrecognition of gain in certain situations in which property lost or sold by the taxpayer is replaced, within a specified period, by property of a similar kind.

Exchanges of partnership interests

Present law does not state specifically whether an interest in one partnership may be exchanged for an interest in another partnership as a tax-free exchange of like-kind property. The Internal Revenue Service has ruled that the exception for interests in financial enterprises applies to partnership interests and thus they do not qualify as like-kind property that may be exchanged tax-free. Rev. Rul. 78-135, 1978-1 C.B. 256. Court decisions have held that exchanges of partnership interest may qualify for tax-free treatment as like-kind property exhanges where the underlying assets of the partnerships are substantially similar in nature. *Estate of Rollin E. Meyer, Sr.*, 58 T.C. 311 (1972), *aff'd per curiam* 503 F. 2d 566 (9th Cir. 1974); *Gulfstream Land and Development Co.*, 71 T.C. 587 (1979). However, the court in the *Estate of Meyer* case held that an exchange of a general partnership interest for a limited partnership interest does not satisfy the like-kind requirement.

Reasons for Change

Deferred like-kind exchanges

The committee is concerned that like-kind treatment of non-simultaneous exchanges has given rise to unintended results and administrative problems. These concerns extend to the underlying policy of the like-kind exchange rule.

The special treatment of like-kind exchanges has been justified on the grounds that a taxpayer making a like-kind exchange has received property similar to the property relinquished and therefore has not effectively "realized" a profit on the transaction. This rationale is less applicable in the case of deferred exchanges. To the extent that the taxpayer is able to defer completion of the transaction—often retaining the right to designate the property to be received at some future point—the transaction begins to resemble less a like-kind exchange and more a sale of one property followed, at some future point, by a purchase of a second property or properties. This is particularly true when (as was the case in the *Starker v. United States*) the taxpayer might have received like-kind or non-like-kind property in the future. The committee believes that like-kind exchange treatment is inappropriate in such situations and that the general rule requiring recognition of gain on sales or exchanges of property should apply to these cases.

The special treatment of like-kind exchanges has also been justified from an administrative standpoint because of the difficulty of valuing property which is exchanged solely or primarily for similar property. This rationale may also be less applicable to deferred like-kind exchanges, in particular exchanges which are "left open" until the taxpayer has selected a suitable exchange property. In such cases, the transferred property must be valued at a specific or near-specific dollar amount in order to determine the aggregate value of the properties that the taxpayer may receive in the future.

Thus, the taxpayer's gain may be measured with reasonable accuracy in the year of the original transfer.

The committee is also concerned that the like-kind exchange rules significantly expand the ability of taxpayers to avoid recognition of gain on deferred payment sales. Unlike other nonrecognition rules (e.g., the rollover of gain on replacement of a principal residence), the like-kind exchange provisions have no express statutory time limit on the availability of nonrecognition treatment. Decisions such as that in *Starker* v. *United States* suggest that there may, in fact, be no limit on the time for which like-kind exchanges may be kept open. If this is the case, taxpayers, by combining the installment sale rules and the like-kind exchange provisions, may defer taxation on dispositions of property for an indefinite period of time, even if a right to receive cash instead of property is retained. If cash is ultimately received, the installment sale rules will achieve a deferral until the time of receipt, while if like-kind property is received, recognition will be even further delayed. By exercising the right to designate property shortly before death, a taxpayer may conceivably avoid any taxation on the sale. Interaction of the installment sale and like-kind exchange rules also raises serious administrative problems regarding the allocation of liabilities and basis among different properties, problems which may not be resolvable until all exchanges and payments required by the agreement have been completed. Thus the tax consequences of deferred exchanges may not be determined for many years after the transaction is initiated.

Exchanges of partnership interests

It is questionable whether the like-kind exchange provisions were originally intended to apply to exchanges of partnership interests. The statute by its own terms does not apply to exchanges of stock, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest (sec. 1031). These exclusions prevent taxpayers from trading investment interests so as to take advantage of like-kind treatment on dispositions of appreciated property. The committee believes that, at least under current conditions, partnership interests typically represent investment interest similar to those items already excluded from like-kind treatment and should therefore be excluded from such treatment.

In reaching the decision above, the committee is particularly concerned by the use of the like-kind exchange rules to facilitate the exchange of interests in tax shelter investments for interests in other partnerships. Under this arrangement, taxation of the gain inherent in an interest in a "burned out" tax shelter partnership—i.e., a partnership which has taken substantial deductions for nonrecourse liabilities without actually paying off such liabilities, and hence without the partners suffering real economic loss—may be avoided if the interest is exchanged, tax-free, for an interest in another partnership. While court decisions have limited like-kind exchange treatment to partnerships holding similar underlying assets, this rule may be inadequate to reflect the actual situation of the two partnerships and may therefore continue to allow abuses of the type above. The committee believes that such abuses are best prevented by specifically excluding partnership interests from the like-kind exchange rule.

Explanation of Provisions

Deferred like-kind exchanges

The bill provides that, for purposes of the like-kind exchange provision, any property received by the taxpayer more than 180 days (but not later than the due date of the taxpayer's tax return) after the date on which the taxpayer relinquishes property is not to be treated as like-kind property. Thus, tax-free treatment will be unavailable for exchanges not completed within this time period.

Exchanges of partnership interests

The bill specifies that the like-kind exchange rules do not apply to any exchange of interests in different partnerships. This rule is not intended to apply to an exchange of interests in the same partnership.

No inference should be drawn from the committee's action regarding the proper treatment of these transactions under present law.

Effective Date

The provision relating to partnership exchanges is effective for transfers of property after March 31, 1984 other than exchanges made pursuant to binding contracts entered into on or before March 1, 1984. The provision relating to deferred like-kind exchanges is effective for transfers after date of enactment. For transfers on or before date of enactment, any property received after December 31, 1986, will not be treated as like-kind property.

Revenue Effect

This provision will increase fiscal year budget receipts by $226 million in 1985, $630 million in 1986, $667 million in 1987, $788 million in 1988, and $842 million in 1989.

8. Allocation of Certain Liabilities to Limited Partners (sec. 79 of the bill and sec. 751 of the Code.)

Present law

In general.—A partner is entitled to deduct his allocable share of partnership losses to the extent of the adjusted basis of his partnership interest. When a partner personally assumes liability for partnership debts, the basis of his interest is increased to the extent of the liabilities assumed. Similarly, a partners' basis in his interest is increased to the extent of his share of partnership liabilities. Treasury regulations provide that, when none of the partners is personally liable for a partnership debt (nonrecourse liabilities), all of the partners, including limited partners, may increase the basis of their interests by their share of the debt, which is determined in accordance with the interest in partnership profits. (Treas. Reg. sec. 1.752-1(e)).

In *Raphan* v. *United States*, (United States Claims Court, No. 452-78, September 26, 1983), the court held that a general partner was not to be treated as personally liable with respect to an otherwise nonrecourse debt because he guaranteed repayment of the debt. Thus, the debt remained a nonrecourse liability and the limited partners were entitled to include a portion of the debt in computing the basis of their partnership interests (thereby increasing the maximum amount of partnership deductions which could be allocated to the limited partners). The Internal Revenue Service has taken a contrary position in a published ruling (Rev. Rul. 83-151, 1983-41 I.R.B. 6).

At-risk rules.—The at-risk rules prevent taxpayers from deducting losses in excess of amounts which the taxpayer actually risks losing as a result of an investment. Because limited partners are not personally liable for partnership liabilities, the at-risk rules, where applicable, generally prevent limited partners from deducting losses in excess of amounts invested in the partnership. The at-risk rules are not applicable to real estate investments.

Reasons for Change

The committee believes the holding in *Raphan* v. *United States* results in an inappropriate increase in the limited partners' basis in their interests. The committee also believes the rules for sharing partnership liabilities under Treasury regulation sec. 1.752-1(b) are outdated and require revision to ensure that the partner receiving the basis with respect to a partnership liability bears (to the extent possible) the economic risk of loss with respect to such liabilities. Similarly, the committee is concerned with the lack of definition of when an "assumption" takes place under section 752.

Explanation of Provision

The bill directs the Treasury Department to prescribe regulations regarding the conditions under which recourse and nonrecourse liabilities may be reflected in the basis of the partners' partnership interests. It is anticipated that these regulations among other things will reflect the position taken in Revenue Ruling 83-151 and will reject the holding in *Raphan* v. *United States*. Thus, the regulations will specify that indebtedness (or portion thereof) for which a general partner is primarily or secondarily liable (whether in his capacity as a partner or otherwise) is not nonrecourse liability providing additional basis for limited partners' interests in a partnership. Similarly, when a limited partner guarantees a liability, the regulations will not shift the basis attributable to that liability away from the limited partner as a result of the guarantee. The committee does not intend that the regulations will alter the general rule allowing nonrecourse liabilities to be included in the basis of limited partners' interests.

The committee anticipates that the regulations discussed above will be effective for amounts paid or incurred after March 1, 1984. The committee, therefore, urges prompt action by the Treasury Department in completing these regulations.

Effective Date

This provision is effective for amounts paid or incurred after March 1, 1984.

Revenue Effect

The effects of this provision are included in the estimated revenues for other partnership provisions.

F. Trust Provisions

1. Trust Distributions (sec. 81 of the bill and sec. 643 of the Code)

Present Law

Under present law, beneficiaries are taxed on amounts distributed from a trust or estate to the extent of the trust's or estate's distributable net income. The trust or estate is allowed a deduction for amounts taxed to its beneficiaries. The present Treasury regulations provide that distributions of property are deemed to carry out distributable net income to the extent of the property's value at the time of distribution. In such a case, there is no gain or loss realized by the trust or estate,[1] and the basis of the property in the hands of the beneficiary is its value to the extent it carries out distributable net income. Treas. Reg. sec. 1.661(a)-2(f).

Reasons for Change

Where a trust or estate has distributable net income and distributes property, the effect of the present Treasury regulations is to exempt the gain or loss entirely from tax. The committee believes that the gain or loss should be taxed to either the beneficiary or the trust (or estate). Accordingly, the committee bill provides that, in general, the distribution of property will be a taxable event resulting in the taxation of the gain or loss to the trust or estate. However, the committee bill provides that, at the election of the trustee or executor, the distribution of property by a trust or estate carries out distributable net income only to the extent of the lesser of the property's basis or fair market value and that the basis of the property carries over to the beneficiary. Under this election, the appreciation will be taxed to the beneficiary when the beneficiary disposes of the property.

Explanation of Provision

Under the committee bill, the distribution of property by a trust or estate results in the recognition of gain or loss on the distribution as if the property had been sold to the beneficiary.[2] Alternatively, the bill allows the trustee or executor to elect to treat distributions of property as carrying out distributable net income only to the extent of the lesser of the property's basis or its fair market value at the time of distribution. If the election is made, the basis of the property in the hands of the beneficiary would be the same as the trust's or estate's.

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[1] Under Rev. Rul. 67-74, 1974-1 C.B. 194, the distribution of property to a beneficiary in satisfaction of his right to receive income currently results in the recognition of gain or loss to the trust.

[2] In the case of depreciable property, section 1239 would apply to deny capital gains treatment on the gain to the trust. See section 167 of the bill which makes section 1239 apply to transactions between trusts and their beneficiaries. Similarly, in the case of a distribution by a trust of property whose fair market value is less than its basis, section 267 would deny a loss deduction to the trust. However, section 267 does not apply to deny a deduction to an estate in such a case.

Effective Date

The provision is effective with respect to distributions made after March 1, 1984, in taxable years ending after that date.

Revenue Effect

This provision will increase fiscal year budget receipts $64 million in 1985, $261 million in 1986 and $409 million in 1987.

2. Taxation of Multiple Trusts (sec. 82 of the bill and sec. 643 of the Code)

Present Law

Trusts are treated as separate taxable entities with respect to certain accumulated and undistributed income (sec. 641). Trusts are taxed under a separate progressive rate schedule (sec. 1(e)).

Treasury regulations enacted following the Tax Reform Act of 1969 provide that multiple trusts will be treated as one trust if they have (1) the same grantor and substantially the same beneficiary, (2) no substantially independent purposes (such as independent dispositive purposes), and (3) as their principal purpose the avoidance or mitigation of progressive rates of tax (including mitigation as a result of deferral of tax) or avoidance or mitigation of the alternative minimum tax.[3]

In *Edward L. Stephenson Trust v. Commissioner*, 81 T.C. No. 22 (September 12, 1983), the Tax Court held that the Treasury regulations regarding multiple trusts were invalid because the Internal Revenue Code did not support a subjective test of tax avoidance motive as a basis for determining the existence of multiple trusts. The court further held that Congress, by enacting a series of more limited rules relating to multiple trusts in the Tax Reform Acts of 1969 and 1976, had implicitly accepted an earlier Tax Court decision which held that the motive for establishing and maintaining multiple trusts was irrelevant for tax purposes.[4]

Reasons for Change

Because of the progressive tax structure, it would be possible to significantly reduce income taxes by establishing multiple trusts having the same grantor and the same or similar beneficiaries. For example, if instead of establishing one $1,000,000 trust a taxpayer establishes ten essentially identical $100,000 trusts, the taxpayer will be able to secure a significantly lower marginal tax rate for the undistributed income of the trusts.

The committee is concerned that, without the restrictions of the existing Treasury regulations persons would be able to significantly reduce the taxation of investment income through the creation of multiple trusts. Accordingly, the committee believes that rules similar to the rules contained in the existing regulations should be legislated by the Congress.

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[3] Treas. Reg. sec. 1.641(a)-0(c).

[4] *Estelle Morris Trusts v. Commissioner*, 51 T.C. 20 (1968), *aff'd per curiam* 427 F.2d 1361 (9th Cir. 1970).

Explanation of Provision

The bill provides that, under Treasury regulations, two or more trusts shall be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and (2) a principal purpose for the existence of the trusts is the avoidance of Federal income tax. For purposes of these rules, a husband and wife are to be treated as one beneficiary or grantor. For this purpose, trusts will not be treated as having different primary beneficiaries merely because the trust has different contingent beneficiaries. Similarly, trusts will not be treated as having different grantors by having different persons making nominal transfers to the trusts.

For example, the committee expects that the Treasury regulations would treat the trusts in the following example as one trust:

> A establishes, with the principal purpose for the avoidance of Federal income tax, trust 1 for the benefit of his sister S1, his brother B1, and his brother B2; trust 2 for the benefit of his sister S2, his brother B1, and his brother B2; trust 3 for the benefit of his sister S1, his sister S2, and his brother B1; and trust 4 for the benefit of his sister S1, his sister S2, and his brother B2. Under each trust instrument, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries.

Where there are substantial independent purposes, and tax purposes are not a principal purpose of the existance of separate trusts, the trusts will not be aggregated. The following is an example where separate trusts will not be aggregated under the committee bill:

> X establishes two irrevocable trusts for the benefit of X's son and daughter. Son is the income beneficiary of the first trust and the trustee (Bank of P) is required to pay all income currently to son for life. Daughter is the remainder beneficiary. X's daughter is an income beneficiary of the second trust and the trust instrument permits the trustee (Bank of D) to accumulate or to pay income, in its discretion, to daughter for her education, support and maintenance. The trustee also may pay income or corpus to son for his medical expenses. Daughter is the remainder beneficiary and will receive the trust corpus upon son's death.

Effective Date

This provision is effective for taxable years beginning after March 1, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $5 million annually.

G. Time Value of Money and Other Accounting Changes

1. Timing and Measurement of Interest Inclusion and Deduction in Deferred Payment Transactions. (Sec. 41 of the Bill and secs. 163(e) and 483 and new secs. 1274 and 1275 of the Code)

Present Law

Timing of inclusion and deduction of deferred interest

OID rules.—If in a lending transaction the borrower receives less than the amount that must be repaid, the difference represents "discount." Discount performs the same function as stated interest; it compensates the lender for the use of its money.[1] Present law (secs. 1232A and 163(e)) generally requires the holder of a discount debt obligation to include in income annually a portion of the original issue discount (OID) on the obligation and allows the issuer of the obligation to deduct a corresponding amount, irrespective of whether the issuer or holder uses the cash or accrual method of accounting (hereafter referred to as the "OID rules").[2]

Original issue discount is defined as the difference between the issue price of an obligation and its stated redemption price at maturity. This amount is allocated over the life of the obligation through a series of adjustments to the issue price for each "bond period" (generally, each one-year period beginning on the date of issue of the bond and each anniversary of that date). The adjustment of the issue price for each bond period is determined by multiplying the adjusted issue price (*i.e.*, the issue price as increased by adjustments prior to the beginning of the bond period) by the obligation's yield to maturity, and then subtracting the interest payable during the bond period. The adjustment of the issue price for any bond period is the amount of OID allocated to that bond period.

Present law provides exceptions to the rules requiring annual recognition and deduction of OID for the following: (1) obligations issued by individuals; (2) obligations with a maturity of less than one year; (3) obligations exempt from tax under section 103 or any other provision of law; (4) obligations issued in exchange for property where neither the obligation nor the property received is publicly traded; (5) obligations issued for the use of property; and (6) obligations issued in exchange for services.[3]

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[1] *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965) (a case decided under the 1939 Code). See also *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[2] The purpose of the OID rules is to ensure that an OID obligation is treated for tax purposes in a manner similar to a nondiscount obligation requiring current payment of interest. They treat the borrower as having constructively paid the lender the annual unpaid interest accruing on the outstanding principal, which amount the borrower may deduct as interest expense and the lender is required to take into income. The lender is then deemed to have relent this amount to the borrower, who must in subsequent periods pay interest on this amount as well as on the original principal. This concept of accruing interest on unpaid interest is often referred to as the "economic accrual" of interest or interest "compounding."

Measurement of interest in deferred payment transactions involving nontraded property

Section 483.—Parties to a deferred payment transaction involving a sale of property may be subject to the unstated interest rules of section 483.[4] If the parties to such a transaction do not specify a minimum (safe-harbor) rate of interest to be paid by the purchaser-borrower, section 483 recharacterizes a portion of principal as unstated interest assuming a higher "imputed" interest rate. The safe-harbor rate is a simple interest rate; the imputed rate is a compound rate. Currently, the safe-harbor and imputed rates are 9 percent and 10 percent, respectively. The maximum imputed interest rate applicable to certain transfers of land between members of the same family is 7 percent.

Section 483 provides exceptions (1) for transactions where the sales price does not exceed $3,000; (2) for payments made pursuant to a transfer described in section 1235(a) (relating to the sale or exchange of patents); (3) in the case of sellers, for sales of property if all of the gain on the sale would be ordinary; and (4) for certain other transactions.

If interest is imputed under section 483, a portion of each deferred payment is treated as unstated interest. The allocation between unstated interest and principal is made on the basis of the size of the deferred payment relative to total deferred payments. Amounts characterized as unstated interest are included in the income of the lender in the year in which the deferred payment is received (in the case of a cash method taxpayer) or due (in the case of an accrual method taxpayer). The borrower correspondingly deducts the imputed interest in the year in which the payment is made or due.

Section 482.—The regulations under section 482, relating to the allocation of income and deductions between commonly controlled organizations, trades or businesses, require a similar imputation of interest in the context of loans and deferred payment sales transactions between commonly controlled businesses where adequate interest is not provided for. The regulations employ a simple interest safe-harbor rate to test the adequacy of stated interest and assume a higher simple interest rate if this rate is not met.

Reasons for Change

Mismatching and noneconomic accrual of interest

The OID rules were enacted in 1969 to eliminate the distortions caused by the mismatching of income and deductions by lenders and borrowers. Prior to that time, an accrual method borrower could deduct deferred interest payable to a cash method lender in a period prior to the period in which the lender took the interest into income. The possibility of such mismatching still may exist in the case of obligations that come within one of the exceptions to the OID rules. Some taxpayers have attempted to exploit these exceptions, particularly the exception relating to obligations issued for nontraded property,[5] to achieve deferral of income tax on interest income and accelerated deductions of interest expense.

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[3] Payments made to employees and nonemployees pursuant to nonqualified plans of deferred compensation are governed by sections 404 and 404A which denies a deduction for such amounts until the year in which they are included in the income of the employee. Present law is unclear as to whether all deferred payments for services are within the scope of sections 404 and 404A.

[4] Section 483 does not apply to transactions covered by the OID rules. See Treas. Reg. secs. 1.483-1(b)(3), 1.483-1(d)(3)(ii).

For example, real estate or machinery may be purchased for notes providing that interest will accrue annually but will not be paid until the notes mature. The issuer, who typically uses the accrual method of accounting, will claim annual interest deductions while the holder, who typically uses the cash method of accounting, will defer interest income until it is actually received. From the government's standpoint, the present value of the income included by the lender in the later period will be less than the present value of the deductions claimed by the borrower. As the disparity between the time when the borrower deducts the interest expense and the time when the lender reports the interest income grows, the revenue loss increases geometrically.[6]

The revenue loss is magnified if the accrual method purchaser computes its interest deduction using a noneconomic formula such as straight-line amortization, simple interest, or the "Rule of 78's."[7] Although the Internal Revenue Service recently issued a revenue ruling which proscribes the deduction of interest in an amount in excess of the economic accrual of interest for the taxable year,[8] the committee understands that some taxpayers are taking the position that this ruling is an incorrect interpretation of present law.

Significant distortions can also occur in connection with deferred payment transactions involving services or the use of property. For example, if a lessor agrees to lease property to the lessee for 5 years for an amount payable at the end of the lease, the lessor has actually made several loans to the lessee, each in the amount of the annual rent. A portion of the amount payable at the end of the 5-year period is unstated interest. If the lessee is an accrual method taxpayer, the lessee will deduct annually a ratable portion of the amount due at the end of the lease. However, if the lessor is a cash method taxpayer, the lessor will report no income until the end of the fifth year when payment is received. Thus, a mismatching of both the amounts representing rent (*i.e.*, loan principal) and the amounts representing unstated interest will have occurred.

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[5] The bill which became the Tax Reform Act of 1969, as reported by this committee and the Senate Finance Committee, included within its scope essentially all transactions involving issuance of a debt obligation for property. A Senate floor amendment added the exception for obligations issued for nontraded property, reflecting concern that the parties to such sales might take inconsistent positions on valuation to the detriment of the Treasury. See letter from John S. Nolan, Deputy Assistant Secretary of the Treasury, to Sen. John J. Williams, dated November 28, 1969, 115 Cong. Rec. 36730-36731 (1969).

[6] The Conference Report to the Technical Corrections Act of 1982, which repealed the exception to section 1232 for publicly traded obligations isssued in a reorganization, specifically referred to the mismatching problem in transactions involving nontraded property and indicated that further legislation might be appropriate in the near future if the Treasury Department was unable to deal with the problem administratively. H. R. Rep. No. 97-986, 97th Cong., 2d Sess. 21 (1982). While the Internal Revenue Service may be successful in challenging the deductions for accruing interest under certain theories, this result is unclear.

[7] The Rule of 78's is a formula for allocating interest over the term of a loan that results in much larger deductions in the early years. To illustrate, in the case of a 30-year loan, interest would be calculated under the Rule of 78's by first taking the sum of the integers from 1 through 30 (*i.e.*, 1+2+3+4. . .and so on up to 30), or 465. The borrower would accrue 30/465 (or 6.45 percent) of the total interest in the first year, 29/645 (6.24 percent) in the second year, and so on until the 30th year, when 1/465 (.22 percent) of the total interest would be accrued.

[8] Rev. Rul. 83-84, 1983-1 C.B. 9.

In view of the significant distortions occurring under present law, the committee believes that it is appropriate to extend the periodic inclusion and deduction rules of existing sections 1232A and 163(e) obligations issued for nontraded property, services, and the use of property, and to obligations issued by individuals. The committee believes that the valuation problems that may arise in situations where neither side of a transaction is traded can be resolved by imputing a conservative rate of interest in appropriate cases. For similar reasons, the committee believes that it is no longer appropriate to exempt holders of obligations that are not capital assets in the holders' hands from the periodic inclusion rules.[9]

Although the OID rules are somewhat complex, the committee believes that they can be extended to a broader range of transactions without disrupting the routine, legitimate transactions of individuals or small businesses, which might have difficulty understanding and applying the rules. The committee's bill exempts many of these transactions. Moreover, individuals rarely issue sizable long-term debt obligations that do not require current payments of interest outside of the context of tax-motivated transactions.

Mismeasurement of interest in transactions involving nontraded property

Recharacterization of interest as principal

The committee recognizes that it is possible in a deferred payment sales transaction involving nontraded property to manipulate the principal amount by understating the interest element of the transaction. Although the parties to a transaction in which interest has been artificially fixed at a below-market rate are, economically, in the same position as if interest had been accurately stated, significant tax advantages may result from characterizing the transaction as one involving low interest and high principal.

If recognized for tax purposes, this mischaracterization of interest as principal could overstate the principal amount of the loan and hence the sales price and tax basis of the property.[10] In cases where the property is a capital asset in the hands of the seller, the seller will have transformed interest income, which should be taxable as ordinary income in the year that it accrues, into capital gain taxable at lower rates and only when paid at maturity. If the property is depreciable in the hands of the purchaser, the inflated basis may enable the purchaser to claim excessive cost recovery (ACRS) deductions and investment tax credits.

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[9] The capital asset exemption was designed to prevent the conversion of ordinary income into capital gain. The committee believes that in light of the increased significance of time value of money, the timing of the recognition of the income is equally important as the character of the income. It is noted that one effect of the bill will be to allow cash method borrowers to claim periodic deductions for discount that under prior law they could deduct only at the maturity of the obligation. Thus, the bill will permit annual interest deductions to an additional group of taxpayers. Particularly in view of this fact, the committee believes that recognition of income by lenders in transactions should not be deferred on the ground that they do not hold an obligation as a capital asset. For similar reasons, the bill will repeal the exception to section 483 for debt instruments received in sales of ordinary income property (sec. 483(f)(3)).

[10] To illustrate, assume a sale of nontraded property, which Seller and Buyer agree is worth $100 in current dollars, and a market interest rate of 12 percent. Buyer agrees to pay, and Seller agrees to accept, a lump sum amount of $179 at the end of 5 years. From an economic perspective, the $179 lump sum payment is comprised of $100 principal and $79 interest. However, the parties could, by stating in the contract that interest will accrue at a rate of 9 percent compounded semiannually, artificially fix the principal amount, and hence the cost of the property, at $115 ($179 discounted to present value at a rate of 9 percent is approximately $115). (As discussed above, parties might also characterize this same transaction as involving a sales price of $115 with annual accruals of simple interest on that amount at a rate of 12.8 percent, thereby accelerating the current interest deductions.)

Inadequacy of section 483 rates

The safe harbor and imputed interest rates provided in section 483 do not represent economic rates of interest for three reasons. First, although the rates have been changed over the years, they have not kept pace with market interest rates. Second, the simple interest computation used in testing the adequacy of stated interest ignores the compounding of interest on unpaid interest which occurs as an economic matter.[11] Finally, the use of a single rate for all obligations regardless of the length of time before maturity fails to reflect the fact that lenders typically demand different returns on investment depending on the term of the loan.

Tax shelters have taken advantage of the artificially low safe harbor rate to obtain excessive ACRS deductions and investment credits, stating interest at just above the test rate and achieving an overstated sales price and tax basis.[12]

Explanation of Provisions

a. *Extension of OID rules*

Overview

The bill will extend the rules for periodic inclusion and deduction of original issue discount by lenders and borrowers to debt instruments issued for nontraded property and which are themselves not publicly traded. It will also repeal the exemption for obligations issued by individuals and the exemption from the income accrual requirement for cash method holders of obligations not held as capital assets (See also sec. 134 of the bill, generally extending the OID and coupon stripping provisions to foreign investors.) Finally, under the bill, the OID rules will be extended to obligations (whether or not represented by a debt instrument in the form of a note or bond) issued for services or the use of property, except in cases where payment is required to occur before the close of the calendar year following the calendar year in which the services will be performed or the property used.

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[11] A debt obligation maturing in 30 years bearing a stated rate of 9 percent simple interest actually bears interest at a rate of 4-1/2 percent on a compound interest basis.

[12] The committee also understands that some shelters are exploiting section 483's method of allocating unstated interest among deferred payments to accelerate several years' interest charges into the year of the sale. To illustrate the potential for abuse, assume property with an established fair market value of $100,000 is sold for $2,500 in cash and two negotiable $100,000 notes, one maturing six months and one day after the sale (payments on an obligation are within the scope of section 483 only if they are due more than 6 months after the sale), the other 30 years after the sale. The present value of the cash and notes, assuming a 12 percent interest rate, would approximately equal the $100,000 value of the property. Since the notes have no stated interest, section 483 imputes interest at a rate of 10 percent, compounded semiannually. Applying this rate, the total unstated interest in the deferred purchase contract is $99,408—the $200,000 aggregate face value of the notes less $100,592, the sum of their present values.

Since the deferred payments are made in two equal installments, the total unstated interest of $99,408 is allocated under section 483 one-half ($49,704) to the first note and one-half to the second. Thus, the purchaser in this example is arguably entitled to deduct as interest almost one-half the cost of the property in the year of purchase when, economically, virtually all of the imputed interest is paid in the second payment although (it is possible that the rules restricting deductions for prepaid interest may apply to limit the amount of the interest deduction in this situation). Although the section 483 rules would otherwise require the seller to recognize the same $49,704 as ordinary income in the year of payment, the seller may be able to avoid this result by disposing of the first note within 6 months of the sale.

Exceptions from the rules will be provided to ensure that they will not ordinarily apply to routine transactions of individual taxpayers, or to *de minimis* transactions of individuals and others.

Nontraded property

The OID rules will apply to obligations issued in exchange for nontraded property, irrespective of whether the obligation is publicly traded. Special rules for determining the amount of the OID are provided where nontraded debt instruments are issued in exchange for nontraded property. "Property" for this purpose will include all tangible and intangible assets of any sort except money. The committee intends that the term money will include only United States currency and checks.

If either side of a transaction is traded, the market value of the traded side will determine the issue price, as under existing law. Where neither side is traded, however, the valuation of the nontraded property will be determined by imputing an interest rate to the transaction at a rate higher than the safe-harbor rate in cases where inadequate interest is provided for. The safe-harbor interest rate used to test the adequacy of interest and the imputed interest rate will be equal to specified percentages of the "applicable Federal rate."

Applicable Federal rate.—The safe-harbor rate will be 110 percent of the applicable Federal rate, and the imputed rate 120 percent of that rate. The applicable Federal rate will be a rate based on the average yield for marketable obligations of the United States government with a comparable maturity. Federal rates will be redetermined by the Secretary at 6-month intervals for 3 categories of obligations: short-term maturity (3 years or less); mid-term maturity (more than 3 years but not more than 9 years); and long-term maturity (more than 9 years). The applicable Federal rate for a transaction will be the rate in effect for that category of maturity as of the first day there is a binding contract for the sale or exchange. The committee expects that debt obligations with characteristics that result in a yield that is substantially above or below a market rate of interest will be disregarded in making the computation of the applicable Federal rates. Thus, for example, the yield on bonds, the face amount of which may be used to satisfy Federal estate tax obligations (so-called "Flower bonds") would not be taken into account.

The committee does not intend that taxpayers be permitted to manipulate transactions in order to obtain a more favorable Federal rate. Thus, in cases where there is evidence that a contract has been renegotiated primarily to take advantage of a lower safe-harbor rate, the Commissioner will be able to hold the parties to the rate in effect at the time the contract was originally entered into based on the statutory requirement that the rate be fixed "as of the first day on which there is a binding contract. . . ."

Transactions to which OID rules apply.—The adequacy of the interest element in a transaction will be determined by comparing the stated redemption price of the debt instrument at maturity to (1) the principal amount determined by discounting, at a rate equal to 110 percent of the applicable Federal rate, all payments due under the instrument, and (2) the principal amount stated in the debt instrument.[13] The obligation will be subject to the OID rules only if either of these amounts is less than the stated redemption price. Accordingly, these rules will be inapplicable so long as interest has been provided at a rate at least equal to 110 percent of the applicable Federal rate and is payable unconditionally at such rate.[14] In cases in which an obligation provides for periodic reductions of principal, the committee expects that the serial obligations rules presently provided in Treasury regulations would apply. (See Treas. Reg. sec. 1.1232-2(b)(2)(iv).) Where the OID rules do not apply, the parties will report the transaction according to the terms of the instrument and their normal methods of accounting.

Determination of principal amount.—If the safe-harbor rate is not satisfied, the principal amount of the instrument will generally be deemed to be the sum of the present values of all payments due under the instrument using a discount rate equal to 120 percent of the applicable Federal rate. In addition, if the transaction involves a potentially abusive situation, the principal amount of any debt instrument received in exchange for property may not exceed the fair market value of the property. A potentially abusive situation includes any transaction involving a "tax shelter" as defined in section 6661(b)(2)(C). It may also include any other situation which because of (1) recent sales transactions, (2) nonrecourse financing, (3) financing with a term beyond the economic life of the property, or (4) other circumstances, is of a type which the Secretary by regulations identifies as having a potential for abuse.

For example, assume that the property that is the subject of a deferred payment sales transaction was bought by the seller 6 months prior to the sale for cash in an amount significantly less than the principal amount of the purchase money loan. Unless the seller has enhanced the value of the property through improvements or the higher purchase price can otherwise be justified, the parties will be limited to this amount as the purchase price, and the principal amount of the loan will be determined accordingly.

Determination of amount of OID.—The amount of original issue discount subject to the periodic inclusion and deduction rules of present law will be the difference between the issue price and the stated redemption price at maturity. The issue price for this purpose would be the principal amount determined by discounting all payments using a discount rate equal to 120 percent of the applicable Federal rate, or the principal amount payable at maturity, whichever is less. The OID determined under this formula will be treated as interest for all purposes of the Code (*e.g.*, secs. 163, 189, 265, and 543).

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[13] It is believed that the use of a safe-harbor rate equal to 110 percent of the applicable Federal rate will roughly correspond to the rate at which a good credit risk can borrow. Consequently, discounting all payments at this rate should provide a liberal estimate of the principal amount (and, therefore, the value of the property or services) involved in the transaction.

[14] Thus, the OID rules will be inapplicable only in cases where there is a matching of interest income and deductions by the parties. If, for example, the parties provide that interest is payable at a rate equal to the applicable Federal rate but accrues at a higher rate, the transaction would be within the OID rules and interest would be included and deducted annually at the higher stated rate.

Likewise, the allocation between principal and interest resulting from application of the OID rules will determine the principal amount of the loan (and therefore the cost of the property or services). For example, under section 453 (relating to installment sales), the total contract price will include debt of the purchaser only to the extent of the principal amount of the debt instrument as determined under these provisions.

The bill gives the Secretary regulatory authority to make appropriate modifications to the treatment under these provisions if, because of varying interest rates, put or call options indefinite maturities, contingent payments, or other circumstances, the tax treatment otherwise accorded to the borrower and lender or the purchaser and seller is inconsistent with the purposes of these provisions. The bill also authorizes the Secretary to require that the amount of the original issue discount and the issue date be set forth on the face instrument. In the case of a privately placed instrument, however, the Secretary may not impose this requirement prior to a disposition of the instrument by the initial holder.

The OID rules will apply only if the obligation represents a bona fide indebtedness of the purchaser or issuer. Thus, if a nonrecourse obligation is given in exchange for property having a value less than the principal amount of the purported debt obligation, the obligation would be disregarded in whole or in part under general principles of tax law.

The bill contains a general requirement that issuers of OID obligations registered with the Securities and Exchange Commission will be required to furnish the Secretary with the amount of the OID on the obligation, the issue date, and other information that may be required by regulations. Issuers required to set forth information on the face of an instrument will be subject to a penalty of $50 for each instrument for which this requirement is not met.

Exceptions.—Under the bill, the periodic inclusion and deduction rules will not apply to debt instruments received by an individual, estate, or testamentary trust, by a small business corporation (as defined in section 1244(c)(3), relating to losses on small business stock), or by a partnership whose capital is not in excess of the limits specified in section 1244(c)(3), in exchange for a farm. This exception would apply only if it can be determined at the time of sale that the sales price cannot exceed $1 million. An aggregation provision, to prevent avoidance of the $1 million limitation by splitting a single transaction into several smaller transactions, will require that sales and exchanges which are part of the same transaction or a series of related transactions be treated as one sale or exchange.

The rules will also not apply to (1) debt instruments received by an individual as consideration for the sale or exchange of a principal residence (as defined in sec. 1034); or (2) debt instruments received as consideration for the sale or exchange of property if the sum of the payments due under the instrument (whether designated principal or interest) and under any other debt instrument received in the sale, and the fair market value of any other consideration received in the sale, does not exceed $250,000. (An aggregation rule similar to that provided under the farm sale exception would be provided to prevent circumvention of the $250,000 limitation.) Finally, an exception is provided with respect to a payment attributable to a transfer of a patent that qualifies for capital gain treatment under section 1235(a), provided such payment is not contingent upon the productivity, use, or disposition of the patent. Thus, the exception would not apply in the case of a deferred lump sum amount payable for a patent.

Deferred payments for services or use of property.—In general, the bill will extend the OID rules to the interest element of transactions involving deferred payments for services or the use of property, unless payment is to be made before the close of the calendar year following the calendar year in which the services are performed or the property is used. However, the rules will not apply to certain transactions the tax consequences of which are governed by the following special provisions: (1) sections 83, 267, 404, or 404A to the extent these provisions require a different treatment of amounts paid for services, (2) section 267 to the extent that section applies to amounts paid for the use of property, or (3) section 706 to the extent that section applies to either payments for services or use of property. The enactment of this provision is not intended to create any inference regarding the proper treatment under present law of deferred payment transactions involving services or the use of property.

The rules also will not apply to transactions in which the total consideration paid for the services or use of property do not exceed $250,000. An aggregation rule similar to that provided for sales or exchanges of property will apply. Under this aggregation rule, a lease of real property for deferred payment of rents in exchange for occupancy rights covering a period of three years (including options to renew) would be treated as involving a single transaction.

Where a transaction is subject to these provisions, the service performer will be treated as having received a debt instrument in exchange for the services performed (or the use of property) during the taxable year. This instrument will be deemed to contain original issue discount equal to the excess of the portion of the deferred payment allocable (under accrual principles) to that taxable year over the present value of that portion of the deferred payment as of the close of the year. The present value will be determined in the same manner present value is determined for obligations issued for nontraded property, using a discount rate equal to 120 percent of the applicable Federal rate. The service recipient will be allowed a deduction for a corresponding amount of OID annually.

Example.—To illustrate, assume that Lessor and Lessee (who are unrelated) enter into a 3-year lease of a piece of machinery beginning on January 1, 1985, under which Lessee will be pay Lessor a lump sum of $300,000 at the end of 3 years. Under the bill, this transaction would be subject to the OID rules because payment for the use of the property in 1985 is not due before the end of the following year. Lessee would be treated as having issued an OID obligation to Lessor as of December 31, 1985. Assuming an applicable

Federal rate of 10 percent, the amount of the OID on that obligation would be $23,255.[15]

In addition, Lessee would be treated as having issued an OID obligation to Lessor as of December 31, 1986, which obligation had OID in the amount of $10,951. In each of the years 1985, 1986, and 1987, Lessor would take into income and Lessee would deduct the appropriate portion of the discount on the obligations constructively issued, in the same manner OID is accounted for under existing law.

b. Modification of rules for making allocations of principal and interest in other deferred payment transactions

Since the scope of the OID rules will be significantly expanded under the bill, the scope of section 483 accordingly will be reduced. Section 483 will apply only in the case of deferred payment transactions involving a sale of property which are exempted from the OID rules (*e.g.*, sales of a principal residence; certain sales of farms; transactions involving total payments of $250,000 or less; and transactions subject to section 483(g)). The bill will revise the interest rates used in section 483 to conform to the new rates used for obligations subject to the OID rules. Thus, the 483 rules will apply using a compound safe-harbor and imputed interest rates, which will vary according to the maturity of the obligation and will be adjusted at 6-month intervals. Interest income or expense computed on an economic accrual basis will be reported or deducted as under present law, that is, when payment is made (in the case of a cash method taxpayer) or due (in the case of an accrual method taxpayer).

The bill retains the exception of present law under which the section 483 rules do not apply to transactions where the sales price does not exceed $3,000 or to amounts constituting annuities under section 72. The bill also retains the present law rule under which the maximum imputed interest rate applicable to real estate transactions between related parties involving $500,000 or less is 7 percent (sec. 483(g)). The exception for sales of ordinary income property in present law will, however, be eliminated.

The bill also continues the exception under section 483 or the transfer of patents when payment is contingent upon the productivity, use, or disposition of the property transferred.[17]

In connection with the revision of section 483, the bill requires that the regulations under section 482 be amended to provide safe-harbor rates consistent with those applicable under section 483 as amended.

Effective Date

The amendments to the OID rules as they relate to nontraded property transactions and to section 483 will generally is effective for sales or exchanges occurring after December 31, 1984. The rule that the principal amount of the debt instrument received in exchange for property may not exceed the fair market value of the property is effective for transactions occurring after March 1, 1984. However, the bill provides an exception to the revised OID and section 483 rules in the case of transactions for which there was a binding commitment in writing on March 1, 1984.

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[15] This example assumes that the rent is the same each of the three years.

[16] This provision will not, however, require matching of the inclusion of the rental element of the payment by the Lessor and the deduction of that element by the Lessee. Thus, if Lessor were a cash method taxpayer and Lessee were an accrual method taxpayer, Lessee would not be precluded from deducting in 1985 that portion of the rent attributable to that year, even though Lessor would not take that amount into income until 1987.

Transactions occurring after March 1, 1984, and prior to the January 1, 1985, will also be subject to a provision which proscribes the limit the deduction of interest prior to the period to which it is properly allocable. However, this limitation will not apply in the case of a debt instrument pursuant to which the issuer of the instrument makes substantially equal annual payments to the holder.

The repeal of the capital asset limitation will be effective for obligations issued after December 31, 1984, for obligations that are not capital assets in the hands of the holder. The new information reporting requirements will be effective for debt obligations issued more than 30 days after the date of enactment of this bill.

Revenue Effect

It is estimated that the provision will increase fiscal year budget receipts by $114 million in 1984, $431 million in 1985, $868 million in 1986, and $1,335 in 1987.

2. Premature Accruals (sec. 91 of the bill and sec. 461 of the Code)

Present Law

General

Under the accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy (the so-called "all events test") (Treas. Reg. sec. 1.461-1 (a)(2)). If the "all events" test is met, an accrual basis taxpayer generally can deduct the face amount of an accrued expense.

Fact of liability

In a number of early cases, the courts held that expenditures are deductible only when the activities that the taxpayer is obligated to perform are in fact performed, not when the "fact" of the obligation to perform is determined. For example, in *Spencer, White & Prentis, Inc.* v. *Commissioner*, 144 F.2d 45 (2d Cir. 1944), a contractor, who was engaged in the construction of a subway system and who was required under contract to restore certain property damaged or otherwise affected by the construction, was denied deductions for the accrued estimated costs of restoration. The court held that the liability for work done after the end of the taxable year had not been incurred because the work had not been performed. The court also held that deductions are only allowable when the taxpayer's liability to pay becomes definite and certain.

More recently, the courts generally have reached a different conclusion: a taxpayer may deduct the amount of a liability if all the events that fix the liability have occurred and the amount can be determined with reasonable accuracy, even though the activities the taxpayer is obligated to perform are not actually performed until a later year. For example, the Fourth Circuit held that surface mining reclamation costs that could be estimated with reasonable accuracy were properly accrued when the land is stripped although the land was not reclaimed until a subsequent year. *Harrold* v. *Commissioner*, 192 F.2d 1002 (4th Cir. 1951).

The position of the Fourth Circuit with respect to strip mining reclamation costs has been followed by courts in other situations. For example, the Ninth Circuit held that the fact of the liability under workmen's compensation laws [18] is determined in uncontested cases in the year in which injury occurs, even though medical services may be rendered and disability may occur at a future time. *Crescent Wharf & Warehouse Co.* v. *Commissioner* , 518 F.2d 772 (9th Cir. 1975).

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[18] Under worker's compensation laws, employers generally are required to pay injured employees' medical expenses and disability benefits. In many cases, the employer's liability to provide benefits extends over several years.

A deduction for a contingent liability generally is not allowed under present law, because all of the events necessary to fix the liability have not yet occurred. However, in one recent case, the Third Circuit held that a taxpayer is allowed to deduct amounts paid to a trust to fund benefits under a negotiated supplemental unemployment benefit plan, including amounts accrued in a "contingent liability account" (at a fixed rate for each hour worked by eligible employees until a target funding amount is reached). *Lukens Steel Co.* v, *Commissioner*, 442 F.2d 1131 (3d Cir. 1971). The fact that the liability was to a group, rather than a specific individual, and that the time of future payment was indefinite, did not bar a deduction under the all events test.

The courts generally have held that the length of time between accrual and performance does not affect whether an amount is properly accruable. However, in *Mooney Aircraft, Inc.* v. *United States*, 420 F.2d 400 (5th Cir. 1969), the court held that a taxpayer, who gave to purchasers of its airplanes a bond redeemable when the plane was permanently retired from service, was not allowed a deduction because the possible interval between accrual and payment was "too long"; the court concluded that the likelihood of payment decreases as the time between accrual and payment increases.

The Internal Revenue Service takes the position that there must be a current liability to pay for an amount to be deductible, and that a deduction should not be allowed where there is a contingency as to payment of an obligation (other than the ability of the obligor to pay). Rev. Rul. 72-34, 1972-1 C.B. 132.

Amount of liability

In order for an amount to be deductible under the all events test, the amount of a liability must be determinable with reasonable accuracy. The courts have interpreted this rule to mean that the amount of the liability, although not definitely ascertained, can be estimated with reasonable accuracy. Generally, technical estimates and estimates based on industry-wide experience or on the experience of the taxpayer have been accepted by the courts as reasonable. However, a rule of thumb estimate generally is not adequate to meet the all events test. In a recent case, the Ninth Circuit permitted the question of the reasonable accuracy of the amount reserved for anticipated liabilities to be determined by estimating the amount of the liability in aggregate rather than on an individual claim basis, as had generally been required in earlier cases. *Kaiser Steel Corp.* v. *United States*, 411 F.2d 235 (9th Cir. 1983).

The Internal Revenue Service generally takes a more restrictive position. Under their view, the exact amount of a liability must be determinable by a computation based on presently known or knowable factors. For example, the Service held that the taxpayer who was in the business of strip mining did not know, nor was it possible to know, the amount of an expenditure since the reclamation work was not rendered by the taxpayer nor did the taxpayer contract with a third party to perform the services (I.R.S. Letter Ruling 7831003).

Reserve accounts

The 1954 Code, as originally enacted, contained a provision allowing accrual method taxpayers to establish reserves for estimated business expenses and to deduct reasonable additions to the reserve (sec. 462). Congress retroactively repealed the provision in 1955 primarily for revenue reasons (Pub. L. 84-74, 69 Stat. 134 (1955)).

Net operating losses

Net operating losses incurred in a taxable year generally may be "carried back" and offset against taxable income of the 3 years first preceding the year of loss and, if not fully absorbed, "carried forward" and offset against taxable income of the 15 years next succeeding the year of loss. A special 10-year carryback is permitted for product liability losses.

Reasons For Change

The committee believes that the rules relating to the time for accrual of a deduction by a taxpayer using the accrual method of accounting should be changed to take into account the time value of money. Recent court decisions in some cases have permitted accrual method taxpayers to deduct currently expenses that are attributable to activities to be performed or amounts to be paid in the future. Allowing a taxpayer to take deductions currently for an amount to be paid in the future overstates the true cost of the expense to the extent the time value of money is not taken into account; the deduction is overstated by the amount the face value exceeds the present value of the expense.

The committee is concerned about the potential revenue loss from such overstated deductions. In many everyday business transactions, taxpayers incur liabilities to pay expenses in the future. The committee believes that because of the large number of transactions in which deductions may be overstated and because of the high interest rates in recent years, the magnitude of the revenue loss may be significant.

Finally, the failure of present law to take into account the time value of money has become the cornerstone for a variety of tax shelters. For example, a tax shelter partnership may obligate itself to pay someone to perform research and development in the future and claim a current deduction for the undiscounted amount of the costs to be incurred.

The committee recognizes that in the case of noncapital items, a taxpayer, theoretically, should be allowed a deduction for either the full amount of a liability when the liability is satisfied or a discounted amount at an earlier time. However, the committee also recognizes that determining the discounted values for all kinds of future expenses would be extraordinarily complex and would be extremely difficult to administer. For instance, a system that allowed current deductions for discounted future expenses would have to include a complex set of rules for recalculating overstated and understated deductions when the future liabilities are reestimated or are actually satisfied at a time, or in an amount, different from that originally projected; a complex recapture mechanism would be required. Furthermore, in the case of capital items, an appropriate discounting system may be equally complex. Therefore, in order to prevent deductions for future expenses in excess of their true cost while avoiding the complexity of a system of discounted valuation, the committee believes that expenses should be accrued only when economic performance occurs.

Explanation of Provision

In general

The bill provides that, in determining whether an amount has been incurred with respect to any item during the taxable year by a taxpayer using the accrual method of accounting, all the events which establish liability for such amount would not be treated as having occurred any earlier than the time economic performance occurs. If economic performance has occurred, the amount is treated as incurred for all purposes of the Code. If amounts incurred are chargeable to a capital account or, under any other provision of the Code, are deductible in a taxable year later than the year when economic performance occurs then such other provisions apply in determining the amount deductible each year.

Economic performance

Economic performance with respect to a particular liability generally occurs when the activities that the taxpayer is obligated to do to satisfy that liability actually are performed. Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs will be determined under the following principles: If the liability of the taxpayer requires a payment to another person for the providing of property or services to the taxpayer by another person, economic performance occurs when such other person provides the property or services. If the liability arises out of the use of property by the taxpayer, economic performance occurs as the taxpayer uses the property. Similarly, if the liability of the taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides the property or renders the services. For example, if a strip mining company engages a contractor to reclaim stripped land, economic performance occurs when the contractor performs the reclamation rather than when the strip mining company enters into a binding contract with the contractor. Likewise, when the strip mining company itself reclaims the land, economic performance occurs when the land is reclaimed. In the case of worker's compensation, tort, and employee benefit liabilities, which require a payment by the taxpayer to another person, economic performance occurs as the payments to such person are made. In the case of any other liability of the taxpayer, economic performance would occur at the time determined under regulations to be prescribed by the Treasury.

Exceptions

The bill provides several exceptions to the economic performance test. Under the first exception, the economic performance requirement would not apply to a liability of the taxpayer to provide benefits to employees of the taxpayer through a plan that meets the requirements for a qualified pension, profit-sharing, or stock bonus plan under section 404 or 404A. Under such arrangements, the taxpayer generally is allowed a deduction when contributions are made to the plan.[19] Second, the economic performance requirement does not apply to contributions to a funded welfare benefit plan to which section 419 applies.[20] Third, the economic performance requirement does not apply to items which other sections of the Code apply, such as the deductions allowable for additions to a reserve for bad debts (sec. 166), accrual of vacation pay (sec. 463), qualified discount coupons (sec. 466), additions to reserves by life and other insurance companies under the rules of subchapter L, and any other provision which specifically provides for a reserve for estimated expenses.

Example

Assume that a taxpayer using the accrual method of accounting closes a manufacturing plant. Under a negotiated contract, the corporation becomes liable to provide medical benefits to the terminated employees for a period ending with the earlier of the death of the employee or 20 years. The corporation's estimated liability (undiscounted) per employee is $200,000: an average of $10,000 per year for 20 years. Assume also that the estimated costs meet the requirement that they can be determined with reasonable accuracy. The present value of the estimated liability is $50,000. In year 5, the corporation's actual liability is $12,000.

Under present law, the corporation may assert a deduction of $200,000, the full face amount of the estimated liability. Under the bill, the corporation could deduct each year only the amount of the actual expense incurred for health benefits provided that year. In year 5, for instance, the corporation would be allowed to deduct $12,000.

Special 10-year loss carryback

The bill provides for a 10-year carryback period for certain deferred liability losses. A deferred statutory or tort liability loss means the lesser of (1) the net operating loss for the year reduced by any foreign expropriation or product liability loss; or (2) the amount allowable as a deduction under this provision which is taken into account in computing the net operating loss for the year and is for an amount incurred with respect to a statutory or tort liability. This rule applies in the case of a liability under Federal or State law, if the act (or failure to act) occurs at least 3 years before the beginning of the taxable year; and in the case of a tort liability, if the liability arises out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurs at least 3 years before the beginning of the year. For example, this rule would apply if a taxpayer incurred a tort liability for failure to protect another person from a hazardous substance, such as chemical waste, over an extended period of time.

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[19] On the other hand, if the taxpayer is required to provide benefits to which section 404 or 404A does not apply, a deduction would be allowed only when payments are made to the employee or other such person.

[20] See section 111 of the bill for special rules dealing with contributions to funded welfare benefit plans.

The 10-year carryback rule will not apply unless the taxpayer used an accrual method of accounting throughout the period or periods during which the act (or failure to act) occurred.

The bill provides a special rule for the net operating loss carrybacks in the case of nuclear power plants. The amount of any net operating loss attributable to the decommissioning of nuclear power plants may be carried back to each of the taxable years during the period beginning with the taxable year in which the plant was placed in service.

Effective Date

The provisions of the bill will apply to amounts with respect to which deductions would be allowable (determined without regard to the provisions of this bill) after the date of enactment of this bill.

Revenue Effect

This provision will increase fiscal year budget receipts by $303 million in 1984, $643 million in 1985, $646 million in 1986 and $603 million in 1987.

3. Prepayments of Expenses (sec. 91 of the bill and sec. 461 of the Code).

Present Law

In general.—A taxpayer is generally allowed a deduction in the taxable year which is the proper taxable year under the method of accounting used in computing taxable income (sec. 461). The two most common methods of accounting are the cash receipts and disbursements method and the accrual method. If, however, the taxpayer's method of accounting does not clearly reflect income, the computation of taxable income must be made under the method which, in the opinion of the Internal Revenue Service, clearly reflects income (sec. 446(b)). Furthermore, the income tax regulations provide that if an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which paid by a taxpayer using the cash receipts and disbursements method of accounting, or in which incurred by a taxpayer using the accrual method of accounting (Treas. Reg. sec. 1.461-1(a)(1) and (2)).

Deductions for interest.—Under the cash receipts and disbursements method of accounting, deductions generally are allowed in the year in which the expenditures are paid. Under present law, if a taxpayer uses the cash receipts and disbursements method to compute taxable income, interest paid by the taxpayer which is properly allocable to any later taxable year is generally treated as paid in the year to which it is allocable; interest is allocable to the period in which the interest represents a charge for the use or forbearance of borrowed money (sec. 461(g)). An accrual method taxpayer can deduct interest (whether or not prepaid) only in the period in which the use of money occurs. Thus, under present law, interest is deductible in the same period for both cash and accrual method taxpayers.

Deductions other than interest.—Present law is unclear as to the proper timing of a deduction for prepaid expenses, other than interest. No specific statutory provision expressly permits expenses to be deducted in full when paid by a taxpayer using the cash receipts and disbursements method of accounting. Such deductions are not allowed, however, to the extent that they result in a material distortion of income.

Generally, the courts have examined all the facts and circumstances in a particular case to determine whether allowing a full deduction for the prepayment would result in a material distortion of income. In determining whether an expenditure results in the creation of an asset having a useful life extending substantially beyond the end of the taxable year, the court in *Zaninovich* v.

Commissioner, 616 F.2d 429 (9th Cir. 1980), adopted a "one-year" rule. Under this rule, prepayments generally may be deducted if they do not provide benefits that extend beyond one year. Thus, under this decision, a calendar-year, cash-basis taxpayer may be able to deduct a lease payment for the next year paid in December of the current year.

Special rule for farm syndicates.—Present law provides limitations on deductions in the case of farming syndicates. A farming syndicate is allowed a deduction for amounts paid for items (such as feed) only in the year in which such items are actually used or consumed, or, if later, in the year otherwise allowable as a deduction. A farming syndicate is defined generally as a partnership or any other enterprise (other than a corporation which is not an S corporation) engaged in farming if (1) interests in the partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency, or (2) if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs (*i.e.*, persons who do not actively participate in the management of the enterprise).

Reasons for Change

Many tax shelters rely on the deductibility of year-end payments for expenses allocable to the following and subsequent taxable years. Thus, cash-basis taxpayers may shelter other income by prepaying expenses (other than interest). Taxpayers may benefit significantly, for example, by accelerating deductions into a high-income year when lower income is anticipated in future years. The benefits can be significant even when the deduction is accelerated only for one year. The committee believes, therefore, that a taxpayer should not be allowed deductions for expenses until the period to which the expenses are allocable.

The committee recognizes, however, that in numerous everyday business transactions expenses are prepaid. To avoid an adverse impact on these normal business transactions, the committee believes that it is appropriate to limit the application of this new rule to tax shelters. Thus, the new rule would apply only where the abuse is most serious. The committee does not intend, however, any negative inference with respect to prepayments of expenses outside the tax shelter context; as under present law, a taxpayer would not be allowed to deduct the amount of an expense if such a deduction would result in a material distortion of income.

The committee believes that this new rule should apply to the trade or business of farming only if the principal purpose is tax avoidance or evasion, or if the trade or business is conducted in a farm syndicate.

Explanation of Provision

Under the bill, a tax shelter computing taxable income under the cash receipts and disbursements method will not be allowed a deduction with respect to any amount earlier than the time at which such amount is treated as incurred. An amount will not be treated as incurred at any time earlier than the time at which economic performance occurs. Thus, a cash basis tax shelter may not deduct an amount until both economic performance occurs and the amount is paid.

The time at which economic performance occurs generally means when services are performed, property provided, use of property occurs or when the liability is otherwise satisfied.[21] When economic performance occurs, and in the case of a cash basis tax shelter, the amount is paid, the amount is treated as paid or incurred for all purposes of the Code. For example, research and experimental expenditures are treated as incurred when the research and experimentation work is performed, at which time the expenditures are allowed as a deduction if the taxpayer so elects under section 174. Likewise, mine development expenditures will be treated as incurred when the mine development activity is performed. At the election of the taxpayer under section 616, such expenditures may be deducted at that time. Also, management fees will be treated as incurred when the management services are rendered. Prepaid supplies will be treated as incurred when the supplies are used.

Under the bill, a tax shelter means (1) a partnership or other enterprise (other than a corporation which is not an S corporation) in which interests have been offered for sale, at any time, in any offering required to be registered with a Federal or State agency; (2) a partnership or other enterprise if more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs (generally investors who do not actively participate in the management of the enterprise); or (3) any partnership, entity, plan, or arrangement which is a tax shelter within the meaning of section 6661(b) (*i.e.*, the principal purpose of which is the avoidance or evasion of Federal income tax.) The committee intends that an offering required to be registered with any Federal or State agency will include any offering filed with, or with respect to which notice is given to such agency.

In determining whether an investment constitutes a tax shelter, the committee intends that consideration will be given to whether there is a reasonable and significant expectation that either (1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset Federal income taxes on income from other sources in that year. Whether an investment is intended to have tax shelter expectations will depend on the objective facts and circumstances of each case. Significant weight will be given to the expectations described in the offering materials to determine whether the investment is a tax shelter. In addition, significant weight will be given to the percentage of total expenses of the plan or arrangement that are prepaid expenses.

However, in the case of the trade or business of farming, the committee intends that the provisions of the bill only apply to a farming syndicate (as defined in sec. 464(c)) or to an arrangement described in (3) above where the amount of prepaid expenses are inordinately large in comparison to the normal expenses of a farm. For purposes of this provision, the trade or business of farming is defined as in section 464(c) (generally the cultivation of land or the raising of any agricultural or horticultural commodity including the raising of animals). It is intended that the bill not apply to a farmer who actively participates in the management of a farm and does not have the principal purpose of avoidance or evasion of Federal income tax.

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[21] For a more detailed description of the definition of economic performance, see section 461(h) as added by the bill.

Effective Date

The provisions of the bill will apply to amounts with respect to which a deduction would be allowable under present law after March 31, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $123 million in 1984, $277 million in 1985, $88 million in 1986 and $106 million in 1987.

H. Provisions Relating to Tax Straddles

(Secs. 101, 102, 103, 104, and 105 of the bill, and secs. 263, 1092, 1234, and 1256 of the Code)

Present Law

The Internal Revenue Code contains specific rules to prevent the use of straddles to defer income or to convert ordinary income and short-term capital gain to long-term capital gain. In general, the deduction of losses from straddle positions involving actively traded personal property (other than stock) is limited to the amount by which losses exceed unrecognized gains on offsetting positions (sec. 1092). Gains and losses on regulated futures contracts ("RFCs") are reported under a mark-to-market rule that corresponds to the daily cash settlement system employed by U.S. commodity futures exchanges to determine margin requirements.

Taxation of stock options

The straddle rules, including the loss-deferral rule, do not apply to domestic exchange-traded stock options with respect to which the maximum exercise period is less than the minimum holding period for long-term capital gain treatment (sec. 1092(d)). Because all domestic exchange-traded stock options currently have a maximum term of approximately nine months, and the required holding period for long-term capital gain treatment is twelve months and one day, all such options are excluded from the straddle rules.

An option is considered an open transaction. The party that acquires property upon the exercise of an option to buy (a "call") or an option to sell (a "put") recognizes no gain or loss because the option and its exercise are, together, viewed as a purchase of the property. Both the holder of a call and the grantor of a put treat the premium paid or received as an adjustment to the purchase price of the underlying property. The party that sells the underlying property recognizes gain or loss. The holder of a put or the grantor of a call treat the premium paid or received as a reduction of the amount realized on the sale of the underlying property.

Gain or loss from the sale or exchange of an option by an option holder is considered gain or loss from the sale or exchange of property that has the same character as the property to which the option relates has, or would have, in the hands of the holder (sec. 1234(a)). For purposes of applying this rule, if a loss is attributable to failure to exercise an option, the option is deemed to have been sold or exchanged. Thus, if the property to which the option relates would be a capital asset in the hands of the holder, capital gain or loss would result. The capital gain or loss would be long-term or short-term depending upon the holding period of the option. These rules apply to options to buy or sell property.

In the case of a grantor of an option, gain or loss from a closing transaction with respect to the option, or the lapse of the option, is treated as short term gain or loss (sec. 1234(b)). Because this rule is stated to apply to options in property (as defined in sec. 1234(b)), it is unclear whether the rule applies to options that settle in (or could be settled in) cash.

Treatment of professional options traders

Historically, gain or loss from transactions in options granted or acquired in the ordinary course of a taxpayer's trade or business is treated as ordinary income or loss. In cases where a taxpayer grants or acquires options in the course of a trade or business and also holds options in connection with investment activities, the rules prescribed by section 1234 apply to the options granted or acquired as investments. Although the matter is not free from doubt, it appears that taxpayers who "make a market" with respect to a particular option are treated as granting or acquiring options in the course of a trade or business.

The short-sale rule

In the case of a "short sale" (*i.e.,* where the taxpayer sells borrowed property and later closes the sale by buying identical property and returning the same to the lender), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer (sec. 1233(a)). The Code contains several rules designed to eliminate specific devices in which short sales could be used to transform short-term gains into long-term gains. Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain upon the closing of the short sale is considered short-term gain, and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale (sec. 1233(b)). These rules prevent a taxpayer from "aging" his holding period so as to convert short-term capital gain into long-term capital gain where the taxpayer has materially reduced his risk of loss. Also, if a taxpayer has held property for more than one year and sells short substantially identical property, any loss on the closing of the short sale is considered long-term capital loss (sec. 1233(d)). This rule is intended to prevent the conversion of long-term capital loss into short-term capital loss.

For purposes of these rules, property includes stock, securities, and commodity futures (sec. 1233(e)(2)(A)), but commodity futures contracts are not considered substantially identical if they call for delivery of the commodity in different calendar months (sec. 1233(e)(2)(B)). In addition, these rules do not apply in the case of hedging transactions in commodity futures (sec. 1233(g)).

For purposes of the short-sale rules, the acquisition of a put is treated as a short sale, and the exercise or failure to exercise such an option is considered as a closing of the short sale (sec. 1233(b)). If the put is acquired at a time when the underlying property has been held by the taxpayer for 12 months or less, or if the underlying property is acquired after acquisition of the put and before its termination, any gain on exercise or termination of the put is short-term capital gain. Further, the holding period of the underlying property is considered to begin on the earlier of (1) the date such property is disposed of pursuant to the put, or (2) the date the put is exercised, is sold, or expires, as the case may be.

However, if a put and the property identified to be used in its exercise are acquired on the same day, the acquisition of the put is not treated as a short sale (sec. 1233(c)). If the put is not exercised, the premium paid for the put is added to the cost basis of the identified property.

Application of wash-sale rule.—The wash-sale rule disallows any loss from the disposition of stock or securities where substantially identical stock or securities (or an option to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date (sec. 1091). Commodity futures are not treated as stock or securities for purposes of this rule. Rev. Rul. 71-568, 1971-2 C.B. 312.

Loss deferral rule

If a taxpayer realizes a loss on the disposition of one or more positions in a straddle, the amount of the loss that can be deducted is limited to the excess of the loss over the unrecognized gain (if any) in offsetting positions. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. Deferred losses are recognized in the first year in which there is no unrecognized gain in offsetting positions.

Exception for identified straddles

The loss-deferral rule does not apply to losses on positions in an identified straddle. To qualify as an identified straddle, all of the positions in the straddle must be acquired on the same day, the straddle must have all its positions closed on the same day or have no positions closed at the end of the taxable year, and the straddle must not be part of a larger straddle. An identified straddle must be clearly marked as such on the taxpayer's records before the close of the day on which it is acquired.

Losses on positions in an identified straddle are treated as sustained not earlier than the day on which the taxpayer disposes of all the positions comprising the straddle.

Hedging exemption

The loss-deferral rule does not apply to hedging transactions. A hedging transaction is a transaction that is executed in the normal course of a trade or business primarily to reduce certain risks, and that results in only ordinary income or loss. To prevent manipulation of the hedging exemption by tax-shelter syndicators, the exemption was made inapplicable to syndicates. A syndicate is defined as any partnership or other entity (other than a corporation that is not an S corporation), if more than 35 percent of the entity's losses during any period are allocable to limited partners or limited entrepreneurs. A hedging transaction must be clearly identified before the close of the day the transaction is entered into.

Treatment of mixed straddles

In general, a straddle composed of both RFCs and positions that are not RFCs is subject to the loss deferral rule, and the RFC positions of the straddle are subject to the mark-to-market rule. However, the RFC positions in a mixed straddle are excluded from the mark-to-market rule if the taxpayer designates the positions as a mixed straddle. If a designated mixed straddle also qualifies as an identified straddle, the mixed straddle is exempt from the loss deferral rule.

Because the RFC positions and the non-RFC positions of a mixed straddle are taxed at different rates (and, possibly, at different times), a mixed straddle presents opportunities to defer tax and to convert long-term capital loss to short-term capital loss or short-term capital gain to long-term capital gain. However, under regulations to be prescribed by the Secretary, mixed straddles will be subject to rules similar to the rules relating to short sales (described above), regardless of whether the straddle is designated as a mixed straddle or qualifies as an identified straddle (sec. 1092(b)). The statute contemplates that, under these rules, recognized losses will be recharacterized in appropriate cases.

Capitalization of interest and carrying charges

Taxpayers are required to capitalize certain otherwise deductible expenditures for property that is held as part or all of an offsetting position, and for charges for the temporary use of property borrowed in connection with a short sale constituting part of a straddle (sec. 263(g)). Expenditures subject to this requirement ("carrying charges") are interest on indebtedness incurred or continued to purchase or carry property, as well as amounts paid or incurred for temporary use of the property in a short sale, or for insuring, storing or transporting the property. The amount of carrying charges required to be capitalized is reduced by any interest income from the property (including original issue and acquisition discount), which is includible in gross income for the taxable year. The capitalization requirement does not apply to hedging transactions (as defined above for purposes of the similar exemption from the loss-deferral rule).

Mark-to-market rule

Each RFC held by a taxpayer at year-end is treated as if it were sold for its fair market value on the last business day of the year (sec. 1256(a)(1)). Ordinarily, the settlement price determined by an exchange for its RFCs on the year's last business day is considered to be the RFC's fair market value. Any gain or loss on the RFC is taken into account for the taxable year, together with the gain or loss on other RFCs that were closed out before the last business day. If a taxpayer holds RFCs at the beginning of a taxable year, any gain or loss subsequently realized on these contracts is adjusted to reflect any gain or loss taken into account with respect to the contracts in a prior year (sec. 1256(a)(2)). The mark-to-market rule is inapplicable to hedging transactions.

Historically, under case law, commodity futures traders have been treated as buying or selling capital assets (unless the taxpayers came within a nonstatutory hedging exemption). By statute, any gain or loss with respect to an RFC that is subject to the mark-to-market rule is treated as if 40 percent of the gain or loss is short-term capital gain or loss, and as if 60 percent is long-term gain or loss. This allocation of capital gain results in a maximum rate of tax of 32 percent for investors other than corporations.

Definition of an RFC

An RFC is a contract that (1) is marked to market under a daily cash settlement system of the type used by U.S. futures exchanges to determine the amount that must be deposited due to losses, or the amount that may be withdrawn in the case of gains, as the result of price changes with respect to the contract during the day, and (2) is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or any board of trade or exchange that Treasury determines to have rules that are adequate to insure compliance with the mark-to-market rules (sec. 1256(b)). Cash settlement futures contracts are included in the definition of an RFC.

Certain foreign currency contracts are treated as RFCs (sec. 1256(g)). For purposes of this rule, a foreign currency contract is defined as a contract that (1) requires delivery of a foreign currency that is also traded through RFCs, (2) is traded in the interbank market, and (3) is entered into at arm's length at a price determined by reference to the price in the interbank market.

Reasons for Change

Taxpayers have attempted to exploit the exemption from the loss-deferral rule for exchange-traded stock options to defer tax on income from unrelated transactions. If effective, these straddles in stock options defer gains from one year to the next by creating a recognized loss on an option that is matched by an unrecognized gain on an offsetting option. A typical abusive straddle involves the acquisition of "deep-in-the-money" offsetting option positions. (A call is in-the-money to the extent that the exercise price (or strike price) is less than the market value of the stock when the option is granted; a put is in-the-money to the extent the strike price exceeds the stock's value.) Regardless of whether the value of the underlying stock increases or decreases, one option position will result in a loss that can be realized for tax purposes, while the other position results in a gain of approximately equal size that can be deferred until the next year. The unrealized gain can be preserved by adopting a new offsetting position to replace the loss position that is disposed of. Although the Internal Revenue Service may be successful in challenging these transactions under rulings and case law, the law is this area is unclear. The committee believes that tax-motivated straddling in stock options or stock is just as objectionable as the straddling in other actively traded property that occurred prior to enactment of the loss-deferral rule.

One widely used investment strategy that would be affected by the extension of the straddle rules to stock options and stock involves writing call options on stock owned by the taxpayer. The committee believes that it may be appropriate to exempt these transactions where they are undertaken primarily to enhance the taxpayer's investment return on the stock and not to reduce the taxpayer's risk of loss on the stock.

The committee is also concerned about the disparity in the tax treatment of options market makers on securities exchanges and professional traders on commodity exchanges. Although the trading activities of these taxpayers are in some respects similar, under the case law, professional commodity traders are traditionally viewed as realizing capital gains or losses on futures transactions. In contrast, it appears that options market makers trading on securities exchanges may be treated as realizing ordinary income or loss with respect to their options transactions. Moreover, an options dealer is considered to be a dealer in property subject to the option. As a result of the ordinary income or loss treatment that may be available to options professionals tax-shelter syndicates purporting to be market makers have attempted to pass through ordinary losses on stock-option straddles to limited partners.

Another area of concern is that taxpayers may take inconsistent positions regarding the application of present law to new investment products that were not traded when the tax straddle rules were enacted in 1981. For example, the treatment of exchange-traded options that settle only in cash may be uncertain. Taxpayers with losses on cash-settlement options may claim ordinary loss treatment, while taxpayers with gains claim capital gain treatment under the rules generally applicable to options. The Technical Corrections Act of 1982 revised the definition of RFCs to expressly include cash-settlement futures contracts. In the view of the committee, the status of cash-settlement options should be clarified. In addition, options on RFCs ("commodity options") are now traded on domestic futures exchanges. Some taxpayers have taken the position that transactions in commodity options qualify for the 32-percent maximum rate of tax on gains provided by the statutory mark-to-market rule. (The Treasury Department has disputed this interpretation of the law.) However, taxpayers with losses may claim that they are subject to the general tax rules for options, and treat their losses as wholly short-term.

The question of the proper tax treatment of new investment products raises a broader issue regarding whether competing investment products traded on different exchanges should be taxed under the same tax regime. For example, as noted above, some taxpayers now claim that options on broad-based stock index futures are subject to the mark-to-market rule, while direct options on broad-based indexes are subject to the general tax rules governing options. A related concern is the proliferation of mixed straddles between products that are subject to a 32-percent maximum rate of tax and products that are taxed at a 50-percent maximum rate. The committee believes that the number of mixed straddles should be limited where possible.

Finally, it has come to the committee's attention that the regulatory authority granted to Treasury to prescribe rules for mixed straddles may not be sufficient to insure the promulgation of rules that are effective.

Explanation of Provisions

Overview

The bill repeals the blanket exceptions from the straddle rules for stock and exchange-traded stock options. More limited exceptions are provided. In addition, the mark-to-market rule and the 32-percent maximum rate of tax are extended to certain exchange-traded options held by investors and to all listed options held by options market makers. Commodity options are also made subject to the mark-to-market rule and accorded the 32-percent maximum rate of tax.

Repeal of exception for certain stock and stock options

Stock

The bill repeals the exception from the tax straddle rules for direct positions in stock. A more limited exception is provided for a straddle all of the positions of which consist of the holding of stock or the short sale of stock. The committee believes that the wash sale rules (sec. 1091) and the short sale rules (sec. 1233) prevent tax avoidance through transactions in stock; and that it is unnecessary to extend the straddle rules to direct positions in stock. However, the exception for positions in stock is inapplicable to stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder. Moreover, as under present law, this exception would not apply to a contract for the purchase of stock (as distinguished from direct ownership of stock).

Exchange-traded stock options

In general, the straddle rules, including the loss-deferral rule, are extended to straddles involving exchange-traded stock options. An exception is provided for qualified covered call writing transactions.

Qualified covered call options

A covered call option is one that is written with respect to stock that is held by the taxpayer (or acquired by the taxpayer in connection with the granting of the option). The granting of a covered call option does not substantially reduce a taxpayer's risk of loss with respect to the underlying stock unless the option is deep-in-the-money. The bill contemplates that taxpayers can continue to write at-the-money and nondeep-in-the-money covered calls, without running afoul of the straddle rules.

In general, a qualified covered call option is an exchange-traded option (i) the gain or loss with respect to which is not ordinary income or loss, (ii) the term of which is more than 30 days, and (iii) which is not deep-in-the-money. The term "deep-in-the-money option" is defined as an option that has a strike price lower than the lowest qualified benchmark. Generally, the "lowest qualified benchmark" is the highest available strike price that is less than the "applicable stock price" (defined below). In the case of an option with a term of more than 90 days and a strike price exceeding $50, the lowest qualified benchmark is the second highest available strike price that is less than the applicable stock price. However, in any case, the lowest qualified benchmark will not be treated as being less than 85 percent of the applicable stock price.

Exchange rules currently provide for strike prices on options at five-dollar intervals (or "benchmarks") for options on stock trading at prices under $100. For stock trading at prices over $100, there are $10 benchmarks. The lowest strike price currently authorized is $10. Thus, for example, with respect to stock trading at $50, an exchange-traded call option with a strike price of $45 or more would qualify for the exception.

The term "applicable stock price" is generally defined as the closing price of the optioned stock on the most recent day on which such stock was traded before the date on which the option was granted. However, if the opening price of the optioned stock on the day the option is granted is greater than 110 percent of the closing price on the last previous trading date, then the opening price of the stock is treated as the applicable stock price.

In general, a qualified covered call option must be written on a national securities exchange registered with the Securities and Exchange Commission ("SEC"). The Secretary may designate other exchanges qualifying for this treatment if the exchange has rules adequate to carry out the purposes of the exception to the straddle rules for qualified covered calls. The bill contemplates that, as a condition of designating an exchange, the Secretary could require that trades on the exchange be subject to information on reporting under section 6045 (relating to reports by brokers).

The Secretary is granted broad regulatory authority to modify the provisions of the bill (*e.g.*, to take account of changes in the practices of options exchanges or to prevent tax avoidance). The committee contemplates that the Secretary will prescribe rules for the determination of the applicable strike price if the options exchanges modify their benchmarks.

Treatment of gain or loss where the taxpayer is the grantor of a call option

The bill provides that, if at any time a taxpayer holds stock and is the grantor of an outstanding option to buy such stock, which option has a strike price that is less than the applicable stock price, then any amount that would otherwise be treated as a long-term capital gain with respect to the stock is treated as a short-term capital gain to the extent of any short-term capital loss recognized on the option. This short-term capital gain character would be preserved where the stock is transferred in a nonrecognition transaction (including a gift).

Extension of mark-to-market rule

The bill extends the mark-to-market rule (including the 60/40 treatment that results in a 32-percent maximum tax rate) to non-equity listed options and dealers' equity options. Rules are provided to prevent limited partners (or entrepreneurs) of an options dealer from recognizing gain or loss from equity options as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss.

Definition of listed option contract

The bill defines a listed option as any option (other than a right to acquire stock from the issuer) that is traded on (or subject to the rules of) a qualified board of trade or exchange. A qualified board or exchange is a national securities exchange registered with the SEC, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or any other exchange or board of trade that the Secretary determines has rules adequate to carry out the purposes of the relevant statutory provisions. The bill contemplates that, as a condition of designating an exchange or board of trade, the Secretary may require information reporting consistent with the rules of section 6045 (relating to returns of brokers).

Equity listed options

An equity option is defined to mean any option to buy or sell stock, and any other option the value of which is determined by reference to an index of stock of the type that is ineligible to be traded on a commodity futures exchange (*e.g.*, an option contract on a sub-index based on the price of nine hotel-casino stocks). The definition of equity option excludes options on broad-based stock indexes (such as the Standard & Poor's 500 index) and options on stock index futures; thus, these options fall within the definition of nonequity options (discussed below). Holders of equity options (other than dealers) remain subject to the general rules for the taxation of options, including the loss-deferral rule.

Nonequity listed options.—A nonequity option is defined as any listed option that is not an equity option. Under the bill, any holder of a nonequity option (whether an options dealer or an investor) is treated as if the option were disposed of at year-end for a price equal to its fair market value, and any gain or loss is taxed as if it were 60-percent long-term and 40-percent short-term (just as the holders of RFCs are treated). All options on RFCs are, by definition, nonequity options under the bill.

Treatment of dealer options

The bill changes the claimed present-law treatment of options market makers and codifies present law with respect to professional commodity traders by providing that both categories of traders are treated as buying and selling capital assets, except to the extent that an option or future is acquired to hedge property that would generate ordinary income or loss. An options dealer is defined as any person who is registered with the SEC and an appropriate national securities exchange as a market maker or specialist in listed options. Under the bill, an options dealer would not recognize ordinary income or loss with respect to his stock and securities transactions, unless the taxpayer is a dealer in stock and securities under general Federal income tax rules (determined without regard to whether options in such property produces ordinary income or loss).

In addition to nonequity options, which are marked-to-market in the hands of all holders, equity options held by options dealers are also subject to the mark-to-market rule and 60/40 treatment. To prevent dealers from passing through 60/40 treatment of equity options to limited investors, the bill provides that 60/40 treatment does not apply to gain or loss on dealer equity options that is allocable to limited partners or limited entrepreneurs (regardless of the percentage of such gain or loss that is so allocated).

Hedging exemption

In general, the hedging exemption under present law remains available. However, the bill limits the ability of certain taxpayers to deduct losses from hedging transactions where the hedging exemption is claimed.

Under the bill, an options dealer who is a dealer in the underlying property is treated the same as a commodity trader who is a dealer in the cash commodity. Thus, neither the loss-deferral rule nor the mark-to-market rule applies to an option or an RFC that is identified as a hedging transaction where gain or loss on both the option or the RFC and the underlying property would be ordinary income or loss (as determined under the bill).

For certain taxpayers, the bill limits the deductibility of any loss on a hedging transaction to the taxable income (determined without regard to such loss) derived from the conduct of the trade or business to which the hedging transaction relates. This provision is intended to prevent the pass through of ordinary losses to limited investors from transactions engaged in by traders who qualify as dealers in the underlying property.

The limitations on the deductibility of hedging losses apply to the following taxpayers: (i) any taxpayer who enters into a hedging transaction relating to stock or securities, (ii) any individual, and (iii) any corporation if at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned by five or fewer individuals. The term "hedging loss" is generally defined as the excess of (i) the allowable deductions for the taxable year attributable to hedging transactions (determined without regard to the rule limiting hedging losses), over (ii) income received or accrued by the taxpayer during such taxable year from such transactions. However, an exception to the limitations on losses is provided for economic losses. The bill provides that the limitations do not apply to a hedging loss to the extent that such loss exceeds the aggregate unrecognized gains from hedging transactions (including gains from hedged property) as of the close of the taxable year. The "aggregate unrecognized gain" is defined as that term is used for purposes of the straddle rules: (i) the amount of gain that would be taken into account with respect to property if such property were sold on the last business day of such taxable year at fair market value, plus (ii) in the case of any position with respect to which, as of the close of the taxable year, gain has been realized but not recognized, the amount of gain so realized.

Cash-settlement options

For cash-settlement options that are not subject to the mark-to-market rule (*e.g.*, narrow-based options on sub-indexes of stock), the bill amends section 1234 to clarify that gain or loss on the sale, exchange, lapse, or exercise of the option is capital gain or loss with respect to grantors or holders. For purposes of the bill, a cash-settlement option is defined as any option which on exercise settles in (or could be settled in) cash or property other than the underlying property. As under present law, the receipt of cash on exercise of a cash-settlement option is a taxable event.

Regulatory authority relating to mixed straddles

The bill broadens the scope of Treasury's regulatory authority to prescribe rules for mixed straddles. The bill requires the Secretary to prescribe such regulations with respect to gain or loss on straddle positions as may be necessary to carry out the purposes of the loss-deferral rule, within six months from the date of enactment. To the extent consistent with this purpose, the regulations should include rules applying the principles of the wash-sale rule and the short-sale rule.

Effective Dates

General rules

In general, the provision repealing the exemption from the straddle rules for stock options and stock applies to positions established after October 31, 1983. However, the application of the straddle rules to offsetting position stock is effective for positions established on or after May 23, 1983.

The special rule for the treatment of gain where the taxpayer is the grantor of an option to buy stock applies to positions established after March 1, 1984.

The provisions extending the mark-to-market rule to nonequity options and dealer equity options generally apply to positions established after the date of enactment. However, with respect to commodity options, the amendments made by the bill apply to positions established after October 31, 1983.

The provision clarifying the treatment of cash-settlement options applies to options purchased or acquired after October 31, 1983. The amendments to the hedging exemption apply to taxable years beginning after December 31, 1984.

Elections

The mark-to-market rules may be applied to nonequity options and dealer equity options on or before the general effective dates under either of two elections provided by the bill.

Positions held on the date of enactment.—Taxpayers can elect to apply the mark-to-market rule to nonequity listed options or dealer options that they held on the date of enactment. The election must cover all such positions held by the taxpayer on the date of enactment.

Positions held on or before the date of enactment.—In lieu of the election described above, taxpayers can elect to apply the mark-to-market rule to all positions held by the taxpayer during the taxable year that includes the date of enactment (the "transition year"). If the taxpayer makes this full-year election, all nonequity listed options and dealer options held at any time during the transition year must be marked-to-market.

With respect to stock options, any tax liability for the transition year which is attributable to appreciation in such options can be paid in two to five equal annual installments. Interest is charged on any unpaid installments of tax that are still outstanding after the due date for the first installment.

Revenue Effect

This provision will increase fiscal year budget receipts by $406 million in 1984, $163 million in 1985, $82 million in 1986 and $60 million in 1987.

I. Employee Benefit Provisions

1. Treatment of Funded Welfare Benefit Plans (sec. 111 of the bill and sec. 419 of the Code)

Present Law

The Code generally allows a deduction for ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business, including a reasonable allowance for salaries and other compensation for personal services actually rendered.[1] The deduction for compensation is limited to amounts that constitute reasonable compensation. Treasury regulations provide for the deduction of amounts "paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan ... if they are ordinary and necessary expenses of the trade or business".[2] Additional limitations and restrictions are provided by other provisions of the Code.[3]

The special deduction-timing rules and rules for measuring deductions that apply to amounts paid under a plan of deferred compensation[4] do not apply to deductions for welfare benefits if those benefits are not regarded as deferred compensation. Neither the Code nor the Treasury regulations provides a definition that clearly distinguishes welfare benefits from deferred compensation. In the past, for example, a plan providing educational benefits to the children of employees was regarded as a plan of deferred compensation and no deductions were allowed for employer contributions to the trust before the benefits were includible in the gross income of the employees.[5] Recently, however, a plan providing educational benefits to employees' children was found to be a welfare plan and the employer was allowed a current deduction for contributions to the plan.[6] If the rules for determining the amount and timing of deductions for contributions paid to deferred compensation plans do not apply to welfare benefit plans, an employer may be allowed a deduction for a contribution under a welfare benefit trust before the benefit is actually provided to an employee.

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[1] Sec. 162(a)(1).

[2] Treas. Reg. sec. 1.162-10(a). Treas. Reg. sec. 1.162-10(c) provides, however, that deductions for contributions under any plan deferring the receipt of compensation are governed by section 404.

[3] See, for example, sec. 264 (deductions for certain life insurance premiums are denied), sec. 267 (deductions for certain accrued but unpaid expenses are denied if the expense is payable to a related, cash method person), and 274 (deductions for certain entertainment, amusement, and recreational facilities are denied if the facilities are not primarily for the benefit of employees other than officers, owners, or highly compensated employees).

[4] Sec. 404. A deduction also is allowed for contributions to provide disability, incidental death benefits and post-retirement medical benefits under a qualified pension plan.

[5] See, for example, Rev. Rul. 75-488, 1975-2 CB 55, and *Citrus Orthopedic Medical Group, Inc.*, 72 TC 461 (1979), *Grant-Jacoby, Inc. v. Commissioner*, 73 T.C. 700 (1980).

[6] *Greensboro Pathology Associates, P.A. v. United States*, 698 F.2d 1196 (Fed. Cir. 1982).

For both cash and accrual method taxpayers, Treasury regulations provide that if an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made or incurred.[7] The regulations provide for ratable amortization of such items. For example, if a cash method taxpayer prepays premiums on insurance provided as an employee benefit, proration of the premiums has generally been required to determine the amount deductible in a particular year.[7a] Proration has also been required in the case of life insurance premiums paid by an accrual method taxpayer.[8]

Reasons for Change

The committee has concluded that the favorable tax treatment of employer contributions to welfare benefit plans, as compared with employer payments of wages and salary, is inappropriate in view of the favorable tax treatment already provided to employees, i.e., the exclusion of many of these benefits from adjusted gross income. In addition, the committee believes that the current rules under which employers may take deductions for plan contributions far in advance of when the benefits are paid allows excessive tax-free accumulation of funds.

The committee's concern has been caused by recent discussion among tax practitioners as to the tax-shelter potential of welfare benefit plans. Commentators have pointed out that the combination of advance deductions for contributions and the availability of tax exemption for certain employee benefit organizations (such as the voluntary employees' beneficiary association or VEBA) provides tax treatment very similar to that provided to qualified pension plans, but with far fewer restrictions. This discussion became considerably more active after the enactment of the pension provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Congress had become concerned that qualified pension plans were being used to provide excessive amounts of tax benefits to relatively high-income individuals. Rules were adopted that lowered the dollar limits on the annual contributions that could be made to qualified pension plans and the benefits that could be paid out of them. In addition, further restrictions on certain plans required increased benefits for rank-and-file employees.

In one article on the use of employee benefit plans as a tax shelter, an example is given of how a small professional corporation may utilize the tax benefits of a severance pay plan funded by a VEBA. In this example, the employees of the corporation are two doctors ages 50 and 55, with annual salaries of $150,000 and $200,000, respectively, and three other workers, ages 20 to 36, with annual salaries of $10,000 to $18,000. The example indicates that the corporation could make tax deductible annual contributions to a tax-exempt VEBA of more than $55,000 annually under terms that would make it unlikely that the three lower-paid employees would receive substantial benefits from the plan. Some of this recent literature also pointed out that a VEBA could be used as a basis for claiming a deduction for the full cost of acquiring ski chalets and yachts for the use of the employees. While a direct purchase of the facility by the employer would only permit deductions over the useful life of the depreciable property.

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[7] Treas. Reg. sec. 1.461-1(a)(1) and (2).

[7a] See Rev. Rul. 70-413, 1970-2 CB. 103.

[8] *Trinity Construction Co., Inc. v. United States*, 424 F.2d 303 (5th Cir. 1970).

Thus, the committee is concerned that substantial advance funding of welfare benefits will ultimately lead to an unacceptable tax burden for many taxpayers who do not participate in these programs. Accordingly, the committee has provided that, as a general matter, employers should not be permitted a current deduction for welfare benefits that may be provided in the future. Instead, the committee believes that employers should generally be permitted to deduct employer contributions to a welfare benefit plan on the same basis as if the employer had provided the benefits directly to the employees. Further, this provision is consistent with the provision on premature accruals elsewhere in this bill, under which a deduction with respect to an employee benefit is not allowed before the benefit is paid. If this provision on funded plans were not also included, accrual-method employers could use funded plans to achieve deductions much earlier than those allowed under the revised accrual rules.

The committee recognizes, however, that it is appropriate to permit a reasonable level of reserves to accumulate in a welfare benefit plan for certain self-funded insurance-type benefits, such as life, accident, sickness, disability, severance pay, supplemental unemployment compensation, and group legal service benefits. Accordingly, although deductions for advance funding already are allowed for disability and post-retirement medical benefits that are part of a qualified pension plan, the committee has provided that an employer also should be permitted to deduct contributions for funding a limited reserve in a welfare benefit plan for these particular benefits.

Explanation of Provision

In general

The bill provides additional rules for determining the timing and the amount of an employer's deduction for a contribution to a funded welfare benefit plan. Under the bill, a contribution which is otherwise deductible under the Code will be deductible only to the extent that it does not exceed the qualified cost of the plan for the taxable year. The limitation also applies to contributions with respect to independent contractors.

Under the bill, if an employer pays or accrues[9] a contribution to a funded welfare benefit plan during a taxable year, and the usual requirements for deductibility are met,[10] the contribution will be deductible for the taxable year in which paid to the extent that it does not exceed the qualified cost of the plan for the year.[11] The bill provides that the qualified cost of a funded welfare benefit plan for a year is generally the sum of (1) the qualified direct cost of the plan for the year, and (2) the reasonable addition to the qualified asset account maintained by the fund for the year. Under the bill, the qualified cost is reduced by the after-tax income of the fund for the year.

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[9] If the taxpayer has elected to deduct accrued vacation pay under section 463, the deduction would be limited to the amount properly accrued under that section for a contribution to the fund providing the vacation pay.

[10] Secs. 162 and 212. Of course, in determining whether compensation is reasonable compensation under sec. 162, welfare benefits provided by the employer are taken into account as compensation.

In the case of a sale of property by an employer to a welfare benefit fund for less than fair market value, the excess of fair market value over the selling price is treated as an employer contribution to the plan. Of course, this rule does not change present law with respect to the disallowance of deductions for losses on transactions between related parties (sec. 267).

Qualified direct cost

The bill provides that the qualified direct cost for any taxable year of the employer is the aggregate amount which would have been allowable as a deduction to a cash method taxpayer with respect to benefits provided during the taxable year if that taxpayer had provided the benefits directly on a current basis. This may include properly allocable administrative costs and insurance premiums as well as direct benefit costs. For example, in the case of a self-insured medical reimbursement plan, the qualified direct cost equals the actual benefit payments made to employees for the taxable year, plus a properly allocable share of the administrative costs of providing such benefits.

With respect to the ownership by the fund of recovery property, the qualified direct cost for a year is the deduction that would have been allowed to the employer under sec. 168 for that property for the year if the employer had owned the recovery property. Thus, in the year of a contribution of recovery property by an employer to a fund under a plan, the contribution would be treated as a sale of the property in that year (as under present law) and, if the property is placed in service that year, the employer would be allowed only the deduction with respect to the first year the property is placed in service under the usual rules for determining deductions for recovery property. [12]

Other rules that generally limit deductions are also "passed through" under the bill to limit deductions with respect to fund contributions. Thus, if an employer contributes amounts that the fund uses for the purchase of land used for an employee recreational facility, no deduction is allowed with respect to this contribution because sec. 263 would not have allowed a deduction if the employer had purchased the land directly. Similarly, other expenses of the fund (such as maintenance expenses) with respect to this facility would be qualified direct costs giving rise to employer deductions only if the requirements of sec. 274 are satisfied. As a further example, fund expenditures for insurance that would not have been deductible under sec. 264 if made directly by the employer are not qualified direct costs and, thus, no deductions are available to the employer with respect to such expenditures.

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[11] The amount would be deductible for the employer's taxable year in which (or with which) the plan year ends.

[12] Sec. 115 of the bill also extends the rules of the Code relating to sales of property between related parties (sec. 1239) to certain exempt organizations.

Under the bill, for the purpose of determining the qualified direct cost, a benefit is to be treated as provided when the benefit would be includible in the gross income of the employee (or would be includible in the employee's gross income but for a provision of the Code).[13]

Qualified asset account

The qualified cost of a funded welfare benefit plan for a taxable year of an employer may include an addition to the qualified asset account under the fund for the year. Under the bill, a qualified asset account consists of assets set aside to provide for the payment of welfare benefits. Plan assets consisting of facilities, such as a child care center, directly used in the provision of such benefits would not be reflected in the account because the facility is used to provide the benefit rather than to provide for the payment of the benefit.

The bill provides limits on the amount of the addition to a qualified asset account for a taxable year of the employer. Under the bill, the addition is generally limited to the amount that would have to be added to the account so that the amount of the account as of the close of any taxable year of the fund ending with or within the employer's taxable year is not to be greater than 75 percent of the average qualified direct cost (other than insurance premiums) of the plan for benefits for which reserves are permitted for the taxable year and the preceding taxable year.[14] Benefits for which reserves may be permitted include benefits payable on account of death, accident or sickness (including disability), unemployment, severance pay or legal expenses.[15]

Under the bill, the addition to the qualified asset account for a year is to be determined on the basis of the difference between the value of the assets in the account at the beginning of the year and the limitation described above (changes in asset values during a year would not affect the balance of the account until the beginning of the next year). The committee expects that Treasury regulations will provide rules for the valuation of assets. Under these regulations, it is expected that the value taken into account for assets at a particulter time generally will be based on the fair market value at that time, although it is expected that bonds and similar debt instruments may be valued on the basis of amortization.

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[13] For example, if an employer contributes to a fund to pay premiums or considerations for insurance under a plan, then the qualified direct cost for the year would be determined on the basis of the cost of the insurance for the period for which the coverage is provided, without regard to whether any part of that cost is excludable from the gross income of an employee. On the other hand, to the extent the liability is self-insured, the time at which benefits would be included would be based on the time at which benefits are paid, rather than the time of current insurance coverage, because this is the time the when benefits would be included if the self-insured benefits were provided directly by the employer on an unfunded basis.

[14] The qualified direct cost of the plan for a period preceding the effective date is to be determined as if the bill were effective for the earlier period. For the first year in which a plan is funded, the qualified direct cost for the preceding year is deemed to be zero, so that the maximum addition to the qualified asset account is based on 37.5 percent of the qualified direct cost for the year.

[15] Of course, the amount allowed as a deduction for an addition to the qualified asset account is also limited by the usual rules for deductibility. Accordingly, the amount allowed as a deduction for a year for an addition to the account is not to exceed the amount considered to be an ordinary and necessary business expense for the year and may be subject to other restrictions (*e.g.*, sec. 263). If it is not appropriate to maintain a reserve to provide a benefit, then under the bill, no amount would be allowed as a deduction for an addition to the qualified asset account.

The committee expects that Treasury regulations relating to the determination of whether an addition to the qualified asset account is an ordinary and necessary business expense will require the use of reasonable actuarial principles and level funding over an appropriate period of years.

The bill provides that the Secretary may, by regulation, allow for higher account limits with respect to benefits for which reserves are permitted in two types of cases. First, a higher limit may be provided if the usual limit would be inadequate to provide a reserve equal to the amount of incurred but unpaid claims that are reasonably expected to be paid before the close of the next taxable year. For example, if the usual limit on the qualified asset account is not adequate to enable the plan to pay, out of such account, the next year's expected disability benefits to individuals who had become disabled before the end of the current taxable year and who are expected to receive benefits before the close of the next taxable year, then the higher limit provided by this rule would be available. Under this provision, the actuarial assumptions on which the higher limit is based must be reasonable in the aggregate. The committee expects that Treasury regulations may require the written opinion of an enrolled actuary[16] with respect to the reasonableness of these assumptions.

In the case of a fund maintained pursuant to a collective bargaining agreement, under Treasury regulations which take into account the special needs of particular plans to accumulate funds, a larger limit will be permitted.[17]

Changeover reserve.—Under the bill, in the case of a plan that holds assets in excess of the limit on the qualified asset account on the effective date, the excess, as of that date, is to be credited to an excess changeover reserve. Thereafter, the qualified direct cost of the plan is to be applied against the excess changeover reserve and is not to be considered to be provided from employer contributions for which a deduction may be allowed under the bill. The bill provides that the application against the excess changeover reserve for a year is not to reduce the balance of that reserve more rapidly than ratably over the first five years ending after March 31, 1984.

After-tax income

The bill provides that the qualified cost for a taxable year under a funded welfare benefit plan is to be reduced by the fund's after-tax income for the year. Under the bill, the after-tax income of a fund for a taxable year is the gross income of the fund, reduced by deductions directly connected with the production of that gross income for the year and by the income tax (if any) imposed on the fund for the year. In determining the gross income of a fund, contributions and other amounts received from employees (dues, fees, etc.) are to be taken into account as income but employer contributions are not to be taken into account. Accordingly, employee contributions, etc., will reduce an employer's qualified cost of a plan for a year. The bill provides that no item is to be taken into account more than once in determining the qualified cost for a year.

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[16] Section 7701(a)(35).

[17] Under the bill, to enable employers to comply with the requirements of the bill, Treasury regulations may require that any fund to which more than one employer contributes notify contributing employers of the percentage (if any) or amount of contributions for a year that is not deductible.

Carryovers

The bill provides for carryovers of excess contributions from years in which contributions exceed the qualified costs to subsequent years. Under the bill, if the amount contributed (or deemed contributed under the carryover rule) to a funded welfare benefit plan by an employer during a taxable year exceeds the qualified cost of the plan for the year, but is otherwise deductible, then the excess is to be treated as an amount paid by the employer under the plan in the succeeding taxable year. Amounts contributed before the effective date and not previously deducted would be deductible under the rules of present law.

Funded welfare benefit plan

Generally, a plan is a funded welfare benefit plan if it provides welfare benefits to employees (or their beneficiaries) and the plan includes a fund.[18] The bill provides, however, that a plan of deferred compensation is not a funded welfare benefit plan.[19] In addition, the bill provides that a plan is not a funded welfare benefit plan to the extent the special rules for transfers of property in connection with services apply in determining the timing or amount of the employer's deduction.[20] The bill provides that if there is no plan, but a method or arrangement of employer contributions or benefits which has the effect of a plan, the rules of the bill are to apply as if there were a plan. In addition, under the bill, if any plan would be a funded welfare plan (including, of course, a method, etc., having the effect of a plan) but for the fact that there is no employee-employer relationship, then the bill is to apply as if there were such a plan.

Aggregation rules

In applying the rules of the bill relating to funded welfare benefit plans, all funds under all welfare benefit plans of an employer are to be treated as a single fund, and all employees who are treated as employed by a single employer under the rules relating to qualified pension plans,[21] are to be treated as employed by a single employer. In addition, as under the rules for qualified pension plans, an individual is to be considered an employee of an employer if the individual is a common-law employee or if the individual is a leased employee.

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[18] The bill defines the term "fund" for this purpose as (1) any organization described in paragraph (7), (9), (17), or (20) of section 501(c) (a social club, a voluntary employee beneficiary's association, a supplemental unemployment benefit trust, or a qualified group legal organization) or (2) any corporation, trust, or other organization that is not exempt from income tax. Such an organization includes a retired lives reserve account maintained by an insurance company. Further, if an employer contributes amounts to an insurance company for benefits that are purely experience-rated (i.e., the employer is entitled to an automatic rebate if the amount paid exceeds benefit claims and is liable if the benefit claims exceed the amount paid), such contributions are considered to have been made to a welfare benefit fund. On the other hand, employer contributions to a separate bank account of the employer or to a subsidiary or other related party would not be considered contributions to a fund.

[19] Section 404 provides deduction rules for domestic plans of deferred compensation. Sec. 404A provides rules for foreign plans of deferred compensation. The bill also provides rules for the treatment of unfunded deferred benefits provided under a plan. Accordingly, except for current, unfunded compensation and current, unfunded benefits, no deduction is to be allowed under sec. 162 or 212 with respect to compensation or benefits except as provided under subchapter D of the Code.

[20] See section 83(h).

[21] Sec. 414(b), (c), and (m).

Effective Date

Generally, the provisions of the bill will apply to contributions paid after March 31, 1984. In the case of a plan maintained under a collective bargaining agreement ratified by March 1, 1984, however, the provision applies to contributions paid after the later of December 31, 1986, or the date on which the collective bargaining agreement of the employer terminates (determined without regard to any extension thereof agreed to after March 31, 1984).

The bill includes a provision designed to prevent an amendment of a plan, made solely to conform to the new requirements, from being treated as a termination that would advance the effective date. This type of non-termination rule is similar to provisions included in the Employee Retirement Income Security Act of 1974 and subsequent legislation. It is not intended to create any inference that a particular agreement would, but for the provision, be considered to be terminated.

2. Treatment of Unfunded Deferred Benefits (sec. 112 of the bill and sec. 404(b) of the Code.)

Present Law

Under present law, a deduction generally is allowed to an employer for a contribution paid under a nonqualified plan of deferred compensation in the taxable year of the employer in which ends the taxable year in which the contribution is includible in the employee's gross income if separate accounts are maintained.[22] These rules also apply to contributions under a method, as well as a plan, of deferring compensation and to independent contractors as well as employees.[22a] Under the rules for nonqualified plans, no deduction is allowed for an employer's contribution unless the contribution meets the usual requirements of the tax law for deductibility (for example, the item must be an ordinary and necessary business expense or an expense with respect to property held for the production of income).

Reasons for Change

The committee is concerned that an employer may promise to provide an employee or independent contractor with a benefit some time in the future and, even though the benefit is not funded, may claim a deduction before the benefit is provided to the employee. Accordingly, the committee has concluded that it is appropriate to provide that if the benefit or other compensation is provided under a plan, method, arrangement, or similar understanding that a benefit will be provided in the future, it will be treated as provided under a plan deferring the receipt of compensation.

In addition, the committee is concerned that there is uncertainty about which of the deduction-timing rules of the Code applies with respect to benefits and the scope of these rules insofar as they affect compensation for services provided by independent contractors.. The committee wishes to emphasize that the special rules governing employer deductions with respect to funded welfare benefit plans, deferred compensation, and other deferred benefits, are provided in lieu of the general deduction-timing rules of the Code relating to compensation and that their applicability should be carefully considered in all cases involving the timing of deductions with respect to compensation for services.

Explanation of Provision

The bill clarifies the distinction between welfare benefits and deferred compensation. Under the bill, any plan providing for deferred benefits for employees, their spouses, or their dependents is to be treated as a plan deferring the receipt of compensation. The test is to be applied by determining whether a benefit would, if considered to be compensation, be considered to be deferred compensation. A benefit that would be considered deferred compensation under this test is a deferred benefit. Of course, the determination of whether a plan defers the receipt of compensation is to be made without regard to any income tax rules excluding the benefit from gross income.

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[22] Sec. 404(a)(5).

[22a] Sec. 404 (b) and (d).

A funded welfare benefit plan would not be considered a plan of deferred compensation. A plan is not to be considered funded merely because the employer has purchased a benefit for employees. For example, a plan under which an employer makes a direct payment to an insurance company to purchase insurance benefits would not generally be considered a funded plan. On the other hand, if an employer makes a direct payment to an insurance company under a plan, pursuant to a typical "administrative services only" agreement under which the insurance company maintains a separate account to provide benefits, then the plan would be considered to be a funded plan because the benefits are purchased by the fund under the agreement.

An unfunded deferred benefit plan would be considered to be a plan of deferred compensation for purposes of the rules relating to the timing and amount of employer deductions for contributions. For example, if a plan provided that current employees will be entitled to life insurance protection after retirement, the benefit would be considered to be deferred compensation with respect to current employees under the bill because, as to those employees, it will not be provided until after retirement.

On the other hand, if a plan only provides current benefits for employees, the plan would not be considered a deferred compensation plan merely because it is expected that the plan will continue in existence. The benefit under such a plan with respect to future service will not be provided if the plan is terminated before that service is performed.

Of course, the provision does not change the tax treatment of the employee with respect to the benefit.

The bill clarifies current law by providing that an arrangement for compensation having the effect of a plan or method deferring the receipt of compensation does not have to be similar to a stock bonus, pension, profit-sharing, or annuity plan to be subject to the deferred compensation deduction-timing rules (sec. 404). Generally, all compensation arrangements which defer receipt of compensation by the employee or independent contractor will be subject to these special deduction-timing rules. For example, under the bill, a limited partnership that uses the accrual method of accounting may not accrue deductions for compensation owed to cash-method taxpayers, who perform services for the partnership, until the partnership taxable year in which such compensation is paid. This rule is consistent with current law, under which amounts of compensation deferred under an employment contract or year-end bonuses declared by a corporate board of directors, but not paid within a brief period of time after the close of the taxable year, are subject to the deduction-timing rules of section 404 to the extent that another Code provision (e.g., sec. 267(a)(2)) does not operate to deny the deduction. However, the committee does not intend that a situation in which the compensation is unconditionally payable in the year the services are performed, but payment is unexpectedly delayed for a brief period of time due to the temporary financial condition of the payor, is to be treated as a deferred compensation arrangement.

It is intended that the Treasury Department will prescribe rules for the application of the exception from application of the deduction-timing rule for accrued compensation paid within a brief time after the close of the taxable year. Even if paid within a brief period of time after the close of the taxable year, a compensation arrangement will be subject to the deduction-timing rules of section 404 unless the delay is consistent with typical payroll practices or is attributable to a temporary shortage of funds which could not reasonably be expected.

Effective Date

The provision applies to amounts paid or incurred after March 31, 1984, in taxable years ending after that date.

3. Additional Requirements for Tax-Exempt Status of Certain Organizations (sec. 113 of the bill and sec. 505 of the Code)

Present Law

Voluntary employees' beneficiary associations (VEBAs)

Statutory requirements

The Code describes VEBAs in the following broad terms: "Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual."

The tax exempt status of a VEBA does not directly affect either (1) the timing or amount of an employer's deduction for contributions to the VEBA or (2) the timing or amount of the inclusion in income of a welfare benefit provided to an employee under a plan. Many VEBAs provide benefits to employees that are excluded from gross income under a specific statutory provision.

Eligibility for membership

Under the regulations, membership in a VEBA must consist of individuals whose eligibility is determined by reference to objective standards that constitute an employment-related common bond. Such a common bond is deemed to exist if eligibility is determined by the following standards: (1) employment by a common employer (or affiliated employers), (2) coverage under one or more collective bargaining agreements, (3) membership in a labor union (or in one or more locals of a national or international labor union), or (4) employment by one of more employers in the same line of business in the same geographic locale. Under these standards, for example, a group of car dealers in the same city or other similarly restricted discrete geographical locale could form a VEBA to provide permissible benefits to their employees.

Membership in a VEBA generally is limited to employees. Under the regulations, the term employee means an individual who has a legal and bona fide relationship of employer and employee (e.g., for employment tax purposes or for purposes of a collective bargaining agreement). An individual is treated as an employee, however, whether or not the individual is a common-law employee, a retired employee, or a surviving spouse and dependents of an employee. A self-employed individual (and spouse and dependents) may be a member in a VEBA (i.e., the regulations deem such an individual to share an employment-related common bond with the individual's employees) provided 90 percent of the membership, on one day of each quarter of the VEBA's taxable year, consists of individuals who are employees.

The regulations provide that membership in a VEBA must be voluntary, which requires an affirmative action by the employee to become a member. An employer may automatically include employees provided no detriment is incurred (e.g., deductions from pay) as a result of membership. Such a detriment can be incurred, however, if membership is imposed pursuant to a collective bargaining agreement or incident to membership in a labor organization.

Under present law, membership in a VEBA may not be limited to one employee.

Association of employees

A VEBA is not considered an association of employees unless the organization is controlled by (1) the membership, (2) independent trustees, or (3) trustees at least some of whom are designated by, or on behalf of, the membership. The regulations provide that a VEBA is treated as being controlled by independent trustees if it is an "employee welfare benefit plan" under the Employee Retirement Income Security Act of 1974 (ERISA). ERISA subjected employee welfare benefit plans to certain reporting and disclosure requirements and minimum fiduciary standards. If these standards are satisfied, the employer (or an officer of the employer) may serve as trustee of the VEBA.

Permissible benefits

In general, a VEBA may provide life [23], sick, accident [24], or other benefits in cash or in kind to members or their dependents or beneficiaries.

The regulations specify that "other" benefits means benefits similar to life, sick, or accident benefits. Under the regulations, such benefits must either (1) be intended to safeguard or improve the health of a member or a member's dependents or (2) protect against a contingency that interrupts or impairs a member's earning power. The following benefits are permissible "other" benefits that the regulations permit a VEBA to provide: (1) vacation benefits, (2) vacation facilities, (3) reimbursed vacation expenses, (4) subsidized recreational activities, (5) child care facilities for pre-school and school age dependents, (6) job readjustment allowances, (7) income maintenance payments in the event of economic dislocation, (8) temporary living expense loans and grants at times of disaster (such as fire or flood), (9) supplemental unemployment compensation benefits [25], (10) severance benefits [26], (11) personal legal services [27], and (12) any benefit provided in the manner permitted under section 302(c)(5) et seq. of the Labor Management Relations Act of 1947.

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[23] A life benefit means a benefit payable, directly or through insurance, by reason of the death of a member or dependent. Although a life benefit may not include any benefit in the nature of a pension or annuity, it may be settled in the form of an annuity rather than a lump sum.

[24] Under the regulations, sick and accident benefits mean amounts furnished in the event of illness or personal injury of a member or dependent, including amounts paid to a member in lieu of income during a period in which a member is unable to work because of sickness or injury (i.e., disability income). Sick benefits also include benefits designed to safeguard or improve the health of members and their dependents and benefits furnished in noncash form, such a benefits in the nature of clinical care services by visiting nurses and transportation furnished for medical care.

Impermissible VEBA benefits under the regulations include the following: (1) commuting expenses, (2) accident or homeowner's insurance benefits for damage to property, (3) malpractice insurance, (4) loans to members (other than distress loans), (5) savings facilities, and (6) any benefit similar to a pension or annuity payable at the time of mandatory or voluntary retirement or any benefit similar to a benefit provided by a profit-sharing or stock bonus plan.[28]

A VEBA benefit is considered to be similar to a pension or retirement benefit if it becomes payable by reason of the passage of time, rather than as the result of an unanticipated event. Severance pay benefits, which can operate in many ways like deferred compensation benefits, are becoming increasingly popular VEBA benefits. In some cases, severance pay benefits have been designed to provide cost-of-living adjustments and actuarial reductions for severance prior to attainment of a specified age. It has been suggested that such benefits more closely resemble pension benefits than severance pay benefits.

Nondiscrimination requirements

The VEBA rules of the Code provide that no part of the net earnings of the VEBA may inure, other than through the payment of permissible benefits, to the benefit of any private shareholder or individual. In general, the proscription is designed to ensure that tax-exempt status will be retained only if the organization is operating for tax-exempt purposes, rather than for the benefit of private individuals. Under the VEBA regulations, a VEBA violates this prohibition against inurement if it does not meet certain nondiscrimination standards.

Under the regulations, eligibility criteria for VEBA membership may not be established or administered in a manner that limits membership to officers, shareholders, or highly compensated employees. Similarly, benefits provided by a VEBA cannot be limited to officers, shareholders, or highly compensated employees and cannot disproportionately favor these employees. Generally, this test is not failed merely because certain benefits (such as life insurance) are provided as a uniform percentage of compensation. Also, the regulations permit disability benefits to be integrated (i.e., reduced) on account of social security disability benefits or any "similar plan."[29]

Upon termination of a VEBA, no assets may revert to employers who have contributed to the VEBA. Thus, the assets must be used to purchase permissible benefits in a manner that does not result in prohibited discrimination. Under the regulations, the assets can be distributed on the basis of objective and reasonable standards that do not result in either unequal payments to similarly situated members or disproportionate payments to the officers, shareholders, or highly compensated employees. If the only members remaining upon termination of the VEBA are officers, shareholders, or highly compensated employees, prohibited discrimination may not result if the assets are distributed to these members in the form of permissible benefits.

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[25] See I.R.C. section 501(c)(17).

[26] Such benefits must constitute a severance pay plan within the meaning of Department of Labor Regs. section 2510.3-2(b).

[27] See I.R.C. section 501(c)(20).

[28] Treas. Reg. sec. 1.501(c)(9)-3(f). The Tax Court specifically upheld the validity of this provision (and sec. 1.501(c)(9)-3(d)) in *Bricklayers Benefit Plans of Delaware Valley, Inc. v. Commissioner*, 81 T.C. 735 (1983).

[29] Integration with social security apparently has been attempted by some plans even though the employee is covered under a pension plan of the employer that is also integrated with social security.

Supplemental unemployment compensation benefit trusts

Prior to 1960, supplemental unemployment compensation benefits generally were funded by the employer through a VEBA. Employers generally could not advance fund these benefits because of the limitation on investment income then provided by section 501(c)(9). Consequently, for taxable years beginning after 1959, Congress provided a tax exemption for a trust designed primarily to provide supplemental unemployment benefits to employees.[30]

Present law provides that a trust forming part of a plan providing for the payment of supplemental unemployment compensation benefits is eligible for tax exemption if (1) it is impossible, at any time prior to the satisfaction of all liabilities, for any part of the assets of the trust to be used for the purpose of providing other than unemployment compensation benefits, (2) the employees eligible for the benefits satisfy a classification that does not discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated employees, and (3) the benefits provided do not discriminate in favor of officers, shareholders, supervisors, or highly compensated employees.

Supplemental unemployment compensation benefits means (1) benefits that are paid to an employee because of involuntary separation from employment with the employer (whether or not temporary) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, and (2) sick and accident benefits that are subordinate to the supplemental unemployment benefits.

In determining whether a supplemental unemployment compensation benefits trust is nondiscriminatory, present law provides that discrimination does not exist merely because the benefits received under the plan bear a uniform relationship to compensation. Similarly, a plan is not discriminatory merely because the benefits under the plan are reduced by a sick, accident, or unemployment benefit received under state or Federal law or merely because eligibility for the benefits is limited to employees who are not eligible for sick, accident, or unemployment benefits under state or Federal law.

Qualified group legal services organization

Under present law, an organization created or organized exclusively to form part of a group legal services plan (within the meaning of sec. 120) may be entitled to tax exemption.

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[30] I.R.C. sec. 501(c)(17).

Reasons for Change

The committee believes that employee benefits funded through a tax exempt organization should not be allowed to discriminate in favor of the employees who influence the design of the benefit plan. The committee is concerned that the rules of present law prohibiting discrimination are not sufficiently clear to prevent abuse of the tax-exempt status provided for voluntary employees' beneficiary associations.

The committee is also concerned that the recent proliferation of tax-exempt organizations used to fund employee benefits has made it increasingly difficult for the Internal Revenue Service to monitor the compliance of these entities with the applicable exemption requirements. Accordingly, the committee believes that it is appropriate to require voluntary employees' beneficiary associations and supplemental unemployment compensation benefit trusts to provide notice of a claim to exempt status.

Explanation of Provision

In general

An association that is otherwise exempt from tax as a voluntary employees' beneficiary association (VEBA) or group legal services organization would not continue to be tax exempt unless it meets new standards provided by the bill. These standards provide more effective rules prohibiting discrimination in favor of highly compensated employees and limit the portion of a benefit that may be used by highly compensated employees. Under the bill, the rules aggregating employees of related employers for purposes of testing qualified pension plans apply (with modifications) in testing VEBAs. Similarly, under the bill, all plans and funds of the employer (and related employers) are to be aggregated. The utilization standard also applies to a supplemental unemployment compensation benefit trust (SUB).

An employee is considered highly compensated if the employee is highly compensated under the rules for medical reimbursement plans (sec. 105(h) (except that an employee is not considered highly compensated on account of the level of compensation unless the employee is among the highest paid 10 percent (rather than 25 percent) of all employees (other than certain excluded employees).

Utilization

The bill provides that no more than 25 percent of a benefit funded by a VEBA during a year may be provided to highly compensated employees. For purposes of the 25-percent test, each class of benefit funded by a VEBA is to be considered separately. For example, medical benefits, life insurance,[31] disability insurance, severance pay, and recreational facilities would each be considered to be a separate class of benefits and each would be tested separately for utilization. In the case of certain benefits, such as medical benefits, the 25-percent test is to be applied to the coverage, or right to cash or in-kind benefits, provided to employees, rather than to the actual payments or claims made. Thus, for example, if all employees are entitled to equal benefits, then the 25-percent test is applied by allocating to each eligible employee an equal share of the total cost of such benefits.

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[31] Accident insurance could be combined with either life insurance or medical benefits.

The committee expects that, in the case of recreational facilities and other benefits that are includible in gross income and that are subject to withholding tax, Treasury regulations will require that utilization be demonstrated by withholding under rules similar to those provided under section 83.

Nondiscrimination

In general, a VEBA meets the nondiscrimination standards of the bill only if, under the plan of that it is a part, (1) each class of benefits is available to employees under a classification which is set forth in the plan and that is found by the Treasury not to be discriminatory in favor of employees who are highly compensated, and (2) such class of benefits provided does not discriminate in favor of highly compensated employees. In testing whether the benefits are available to a nondiscriminatory classification of employees, employees who decline to make required contributions must be considered.

Under the bill, however, if a plan provides a benefit of a type for which a nondiscrimination standard is provided by the Code as a condition of an exclusion from gross income, that benefit is not subject to the general nondiscrimination standard. Such a benefit will be considered to be nondiscriminatory if and only if it meets the nondiscrimination standard of the applicable provision of the Code. For example, benefits provided under a medical reimbursement plan would meet the nondiscrimination standard under a VEBA if, and only if, they meet the nondiscrimination standard provided for such plans by section 105(h)(3) and (4).

The bill overrides the nondiscrimination rules of present law for those VEBAs subject to the rules of the bill. The nondiscrimination standards of the bill do not apply to a VEBA maintained pursuant to a collective bargaining agreement. Of course, such VEBAs continue to be subject to the nondiscrimination standards of present law.

In determining whether the nondiscrimination standards are satisfied, the committee intends that the Secretary may take into consideration benefits that vary on account of reasonable and significant geographic disparities.

As under present law, the nondiscrimination standards are applicable with respect to the form of a plan (or exempt organization), its operation, and its termination.

Under the nondiscrimination standard for benefits provided by a VEBA, a life, disability, severance pay, and supplemental unemployment compensation benefit is not considered to be discriminatory merely because the benefit bears a uniform relationship to the total compensation, or to the basic or regular rate of compensation, of covered employees. Generally, such a benefit could not be integrated with social security benefits or benefits under a qualified plan or a simplified employee pension. In the case of a disability benefit, however, integration with the employer-provided portion of social security disability benefits (or contributions) is allowed to the extent employer-provided social security disability benefits (or contributions) are not taken into account under a qualified pension, profit-sharing, or stock bonus plan, or under a simplified employee pension.

Notice of claim of exempt status

Under the bill, a VEBA or SUB would be required to notify the Internal Revenue Service that it is applying for recognition of its exempt status. The committee believes that such notice is required for efficient administration of the tax law. Organizations that have previously notified the IRS are not required, under the bill, to renotify the IRS.

Under the bill, an organization is not exempt as a VEBA or a SUB unless it has given the notice in the manner required by Treasury regulations. The organization will not be exempt as a VEBA or a SUB for any period before the notice is given if the notice is given after the time prescribed by the regulations. In the case of an organization that is in existence on March 31, 1984, the time for giving the notice is not to expire before the end of 1 year after the date of enactment.

Related employers, etc.

The bill provides that, in testing a VEBA, rules similar to the rules of secs. 414(b), (c), (m), and (n) apply. In addition, under these rules, all plans and funds (within the meaning of sec. 419(e)) maintained by an employer (or related employers) are aggregated.

Supplemental unemployment compensation benefits

Under the bill, the special and utilization test, will apply to a supplemental unemployment compensation benefit trust.[32]

Group legal service organizations

Under the bill, all of the new rules applicable to a VEBA will apply to a group legal service organization.

Effective date

These provisions of the bill apply for taxable years beginning after December 31, 1984.

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[32] Sec. 501(c)(17).

4. Amendments to Tax on Unrelated Business Income (sec. 114 of the bill and sec. 512 of the Code.)

Present Law

Under present law, tax-exempt organizations generally are subject to income taxes on income from an unrelated trade or business. In the case of a voluntary employees' beneficiary association (VEBA), income of the association generally is not subject to the tax on unrelated business income to the extent the income is "set aside" to provide permissible benefits. Present law does not specifically limit the amount of income that can be set aside.

Reasons for Change

The committee believes that there should be reasonable limits on the extent to which a tax-exempt entity, such as a voluntary employees' beneficiary association (VEBA) or supplemental unemployment compensation benefit trust (SUB), may accumulate income, tax-free. Also, the committee believes that tax-exempt accumulations should not be permitted for certain benefits that may be provided under a VEBA or SUB. Accordingly, the committee believes that it is appropriate to impose reasonable limits on the amounts that may be set aside on a tax-exempt basis, and that reserves should not be allowed except with respect to self-funded life, sickness, accident, severance pay, supplemental unemployment compensation benefits, and group legal services.

Explanation of Provision

The bill provides that a voluntary employees' beneficiary association (VEBA), a supplemental unemployment compensation benefit trust (SUB) or a group legal service organization may set aside assets, tax free, only for the purpose of providing for the payment of life, accident, sickness, severance pay, supplemental unemployment compensation, or group legal service benefits. Under the bill, the amount set aside, tax free, for these purposes is not to exceed the level of the qualified asset account determined under the rules relating to deductions for contributions to the VEBA, etc.

The committee intends that regulations will provide a method for allocating any unrelated business income among employers contributing to a VEBA, etc.

Effective Date

The provision applies to taxable years beginning after December 31, 1984.

5. Employer and Employee Benefit Association Treated as Related Persons under Section 1239 (sec. 115 of the bill and sec. 1239 of the Code.)

Present Law

Under present law, the gain from the sale of depreciable property between certain related taxpayers is treated as ordinary income. The rules of present law do not treat an employer and the exempt benefit organization to which the employer contributes as related parties.

Reasons for Change

The committee is concerned that employers may be encouraged to assign inappropriate values to property contributed to an employer-controlled fund under a funded welfare benefit plan. Accordingly, the committee believes that it is appropriate to treat such a transaction as a transaction between related parties and, thus, any gain realized by the employer would be treated as ordinary income instead of capital gain.

Explanation of Provision

Under the bill, certain exempt organizations would be treated as related parties with respect to an employer under the rules of the Code treating gain on certain transactions as ordinary income. The bill provides that an employer (and any person related to the employer) would be considered to be related to an exempt social club, voluntary employees' beneficiary association, supplemental unemployment compensation benefit trust, or a group legal service organization (secs. 501(c)(7), (9), (17), or (20)), which is controlled directly or indirectly by the employer, by a person related to the employer, or by the employer and a person related to the employer.

Effective Date

The provision would apply to sales or exchanges after December 31, 1984, in taxable years ending after that date.

6. Treatment of Certain Medical, etc., Benefits Under Section 415 (sec. 116 of the bill and secs. 401 and 415 of the Code.)

Present Law

Present law permits a tax-qualified pension, profit-sharing, or stock bonus plan ("qualified pension plan") to provide for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents. If benefits are provided under a defined contribution plan, except for certain unallocated amounts that are permitted under the overall limits on contributions and benefits, present law requires that a separate allocated account be maintained for each participant. Such separate accounts generally are not required under a defined benefit plan. A plan providing medical benefits must not discriminate in favor of employees who are officers, shareholders, or highly compensated as to the availability or amount of the benefits. In addition, as is the case for all other benefits under a qualified defined benefit or money purchase pension plan, a medical benefit must be definitely determinable.

Under present law, a plan providing post-retirement medical benefits must meet certain requirements. The medical benefit, when added to any life insurance protection provided under the plan, must be subordinate to the retirement benefits provided by the plan. The medical benefits are considered subordinate to the retirement benefits if, at all times, the aggregate of contributions to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions, other than contributions to fund past service credits.

In addition, present law requires that upon satisfaction of liabilities under the plan for post-retirement medical benefits, the remaining assets must revert to the employer and cannot be distributed to the retired employees. If an individual's right to medical benefits is forfeited, the forfeiture must be applied to reduce the employer's future contributions for post-retirement medical benefits.

If the requirements with respect to post-retirement medical benefits are met, employer contributions to fund these benefits are deductible under the general rules relating to deductions for contributions to qualified pension plans. The amount deductible may not exceed the total cost of providing the medical benefits, determined in accordance with any generally accepted actuarial method that is reasonable in view of the provisions and coverage of the plan, the funding medium, and any other relevant considerations. In addition, the amount deductible for any taxable year may not exceed the greater of (1) an amount determined by allocating the remaining unfunded costs as a level amount or a level percentage of compensation over the remaining future service of each employee or (2)

10 percent of the cost that would be required completely to fund or purchase such medical benefits.

Under present law, post-retirement medical benefits are not covered by the rules governing the dollar limits on contributions and benefits that may be provided under a qualified defined benefit pension plan.

Reasons for Change

The committee understands that substantial amounts are being contributed to qualified defined benefit plans, to provide post-retirement medical benefits of employees with significant ownership interests in their employers. The committee believes that the favorable tax treatment accorded these contributions may be subject to abuse unless they are taken into account under the overall limits on contributions and benefits. Accordingly, the committee believes that employer contributions to qualified pension plans on behalf of significant owners for medical benefits should be subject to these limits.

Explanation of Provision

In applying the overall limits on contributions and benefits under qualified pension plans, the bill provides that any contributions allocated to an individual medical benefit account (sec. 401(h)(2)) of an employee under a qualified defined benefit plan is to be treated as an annual addition under a qualified defined contribution plan. Accordingly, the amount allocated for a year would be included, together with employer contributions and reallocated forfeitures, in determining whether the defined benefit plan and any defined contribution plan of the employer meet the separate limits and the combined limits provided with respect to such plans. To the extent provided by Treasury regulations, an amount allocated to a medical benefit account under a defined benefit plan before the effective date of the provision could be reallocated to the individual medical benefit account of a participant without inclusion in the annual addition.

The bill provides that an account is an individual medical benefit account if it is established for a participant in a defined benefit plan, all medical benefits permitted to be paid under the plan with respect to the participant, the participant's spouse, or their dependents are payable solely from the account, and the account may be used for no other participant.

Under the bill, a defined benefit plan that provides medical benefits for retired employees is required to maintain an individual medical benefit account for any plan participant who, at any time during any of the 5 preceding plan years, is a 5-percent owner (as defined in sec. 416(i)(1)(B)(i)). Of course, the medical benefits provided under a qualified defined benefit plan are required to meet nondiscrimination standards.

Effective Date

The provision applies to years beginning after March 31, 1984.

7. Limitation on Accrual of Vacation Pay (sec. 117 of the bili and sec. 463 of the Code)

Present Law

Under present law, an employer using an accrual method of accounting may claim a deduction for vacation pay earned by an employee when the employee's right to the pay becomes vested, that is, not subject to termination if employment ends before the scheduled period or some other contingency occurs. Alternatively, the employer may make an election under section 463 to deduct an amount representing a reasonable addition to a reserve account for contingent vacation pay earned by employees in the current year and payable by the close of that year or within 12 months thereafter. A deduction is allowed in the current year regardless of when the amount is actually paid, so long as the employees have a right to receive the payments during that year or the following year.

Reasons for Change

The committee understands that, for a taxable year, some employers are accruing and deducting vacation pay that becomes payable during the twelve months after the end of the taxable year, even though it is not reasonable to expect that all of the vacation pay will be paid during such period. The committee believes that the deductions allowed in advance of the actual payment of vacation pay under the special rules for this pay should be limited to the amount that the employer reasonably expects to pay during the twelve months after the end of the employer's taxable year.

Explanation of Provision

The bill amends the special rules for the deductions by accrual method taxpayers for vacation pay so that the deduction for a year equals a reasonable addition to the account representing the taxpayer's liability for vacation pay (contingent or vested) earned by employees before the close of the taxable year and expected to be paid during the taxable year or within 12 months following the close of the taxable year. For example, in the case of a taxpayer who makes this determination at the end of a taxable year, the reasonable addition for the year is the amount necessary so that the balance in the account at the beginning of the next taxable year is the amount reasonably expected to be paid in that year. Thus, if the balance in the account, before any addition, is greater than this amount, no additional deduction is allowed. The present law rules that also allow a deduction for reductions in certain suspense accounts are retained.

Effective Date

The provision applies to taxable years beginning after March 31, 1984.

8. Determination of Whether There Is a Collective Bargaining Agreement (sec. 118 of the bill and sec. 7701(a)(42) of the Code)

Present Law

Under present law, many of the nondiscrimination standards of the Code applicable to tax-qualified pension, profit-sharing, and stock bonus plans and certain statutory fringe benefit programs do not apply to plans or programs maintained pursuant to a collective bargaining agreement.

Reasons for Change

The committee is concerned that, in some circumstances, owners, officers, and executives of an employer are forming collective bargaining units for purposes of qualifying for the special treatment accorded to qualified plans and to certain fringe benefits with respect to employees covered by collective bargaining agreements. This treatment was intended to be limited to legitimate collective bargaining agreements and was not intended to provide a means of avoiding obligations to employees through contrived negotiations between an employer's management, sitting as an employer, and itself, sitting as an employee representative.

The committee believes that if a significant portion of the employees covered by a collective bargaining agreement are owners, officers, or executives of the employer (or employers), the special treatment of qualified pension plans and welfare plans with respect to employees covered by collective bargaining agreements should not be available.

Explanation of Provision

The bill clarifies present law by providing that, under the Code, in determining whether there is a collective bargaining agreement between employee representatives and one or more employers, an organization is not to be considered an employee representative if more than one-half of its members are employees (including a self-employed individual who is considered to be an employee under the rules for qualified pension plans) who are owners, officers, or executives of the employer.

Effective Date

The provision takes effect on April 1, 1984.

9. Disqualification of Plan Where Substantially All Contributions are Employee Contributions (sec. 119 of the bill and sec. 401 of the Code)

Present Law

Under a tax-qualified pension, profit-sharing, or stock bonus plan ("qualified pension plan"), qualified annuity plan, a tax-sheltered annuity, or a government plan, contributions may be made by (1) the employer, (2) the employees, or (3) both. Thus, present law permits a qualified pension plan to be funded solely by employee contributions.

Employee contributions to a qualified pension plan generally are not deductible by the employee. Contributions by an employee that meet certain requirements, which are similar to the rules relating to IRAs, may be deductible from gross income. Employee contributions to a qualified plan (whether or not deductible) may not discriminate in favor of employees who are officers, shareholders, or highly compensated. Generally, employee contributions are presumed to be nondiscriminatory if (1) the amount contributed does not exceed certain limits expressed as a percentage of pay and (2) the opportunity to make the contributions is reasonably available to a nondiscriminatory group of employees.

Nondeductible employee contributions may be withdrawn from a qualified pension plan at any time without a tax penalty. In addition, the first withdrawals of nondeductible contributions are treated as a return of the nondeductible contributions, which are not includible in gross income. After the balance of the nondeductible contributions has been exhausted, other withdrawals are considered to be income.

Reasons for Change

The committee understands that some financial institutions are promoting master and prototype qualified pension plans that provide for no employer contributions, but instead permit only nondeductible employee contributions. The favorable tax treatment of amounts under qualified plans and the ready availability of amounts attributable to employee contributions enable these plans to be used as tax-favored savings and brokerage accounts that offer employees the opportunity to withdraw funds using credit cards or checks without any amount being included in the employee's income. Clearly plans used in such a manner are not bona fide retirement plans. The committee believes that a plan should not be treated as a qualified plan if substantially all of the benefits under the plan are attributable to employee contributions.

Explanation of Provision

The bill provides that a plan is not a qualified plan (and a trust under the plan is not a qualified trust) if substantially all of the accrued benefits under the plan are derived from employee contributions. The provision applies without regard to whether the employee contributions are deductible. In determining whether a plan meets the requirements of the bill, the committee intends that each plan be tested separately. Accordingly, a plan would not be treated as meeting the requirements of the bill merely because accrued benefits derived from employer contributions are provided under another plan of the employer.

The committee does not intend that a plan should lose its qualification merely because substantially all benefits attributable to employer contributions have been distributed under the plan, so long as the plan continues to provide for the accrual of employer-provided benefits that will, when accrued, be substantial in relation to benefits derived from employee contributions, and it is reasonable to expect that the future accruals will occur.

Of course, the bill does not affect the status of an organization that is exempt from tax under other provisions of the Code. In particular, the exempt status of an organization that is exempt under section 501(c)(5) would not be affected.

Under the bill, a profit-sharing plan is not to be disqualified merely because employer contributions have not been made due to the employer's lack of profits.

Effective Date

The provision applies to plan years beginning after March 31, 1984.

10. Discrimination Standards Applicable to Cash or Deferred Arrangements (sec. 120 of the Bill and sec. 401(k) of the Code)

Present Law

Under present law, if a tax-qualified profit-sharing or stock bonus plan meets certain requirements (a "qualified cash-or-deferred arrangement"), then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash.

Present law provides that the amount a highly paid employee can elect to defer, tax-free, under a qualified cash-or-deferred arrangement depends (in part) on the level of elective deferrals by other highly paid employees because a limit is applied to deferrals by the group of highly paid employees. An employee is considered highly paid, for this purpose, if he is one of the highest paid 1/3 of the employees.

The special tests applicable to a cash-or-deferred arrangement do not permit employer-provided social security benefits to be taken into account in determining whether a cash-or-deferred arrangement is discriminatory. However, proposed Treasury regulations permit a cash-or-deferred arrangement to satisfy the general nondiscrimination standards applicable to qualified plans, which permit social security to be taken into account in testing for discrimination.

Reasons for Change

The committee is concerned that the present law permits employees the flexibility either to receive cash or to have amounts deferred as employer contributions under cash-or-deferred arrangements even though the employer contributions under such arrangements satisfy only the general nondiscrimination rules applicable to qualified plans rather than the special nondiscrimination tests contained in section 401(k). Because, for example, the general nondiscrimination rules allow employer social security taxes to be counted as employer contributions, the use of these rules may permit too high a difference between the actual deferrals of highly paid and other employees. Thus, the committee believes that a cash-or-deferred arrangement should not be treated as a qualified cash-or-deferred arrangement under section 401(k) unless it satisfies the special nondiscrimination test.

Explanation of Provision

Under the provision, a cash-or-deferred arrangement is a qualified cash-or-deferred arrangement only if it meets the special tests provided by the Code relating to actual deferral percentages. If a cash-or-deferred arrangement fails to meet the special tests, an elective deferral made under the arrangement is treated as an employee contribution under the plan which, under the usual rules, could be wholly or partly nondeductible. The failure of a cash-or-deferred arrangement to meet the special tests does not result in the disqualification of a plan if the plan continues to meet the usual requirements for qualification.

Effective Date

The provision applies to plan years beginning after December 31, 1984.

11. Revenue Effect of Employee Benefit Provisions

These provisions will increase fiscal year budget receipts by $23 million in 1984, $146 million in 1985, $178 million in 1986, and $224 million in 1987.

J. Foreign Provisions

1. Income From Factoring Trade Receivables (sec. 131 of the bill and secs. 553, 861, 954 and 956 of the Code).

Present Law

When goods or services are sold on credit rather than for cash, the seller generally takes from the purchaser a receivable—a transferable promise to pay cash in the future. A common financing technique is for the seller to then sell the receivable to a third party (a "factor") at a discount. The seller's income on the sale of the goods or services is reduced by the amount of that discount, and upon payment of the obligation, the factor realizes income equal to the difference between the amount received and the amount the factor paid for the receivable.

The Tax Court, in *Elk Discount Corp.* v. *Commissioner*, 4 T.C. 196 (1944), held that the discount, or factoring income earned by an active factoring business is not interest within the definition of personal holding company income. In that case, both the seller of the receivable and the factor were U.S. corporations doing business in the United States. A number of issues have arisen under present law as to the tax treatment of such a factoring transaction when the factor is a controlled foreign corporation related to the seller. Arguably, the factoring income could be subject to the anti-tax haven activity rules of subpart F as interest or as income from the performance of services for a related party. However, the Internal Revenue Service has held in one instance that factoring income was not interest for purposes of subpart F (private letter ruling 8338043, June 17, 1983). The Service has not ruled on the services income issue. The purchase of the receivable of a U.S. person from the related U.S. corporation could be treated as an investment in U.S. property on which the U.S. shareholders of the controlled foreign corporation would be taxable (sec. 956). It might also be argued that a foreign corporation factoring U.S. receivables is engaged in business in the United States, and that the factoring income is, therefore, subject to U.S. tax.

In each of the above cases, taxpayers have taken positions which, if sustained, would result in no current U.S. tax either to the controlled foreign corporation or to its U.S. shareholders.

In addition, taxpayers are attempting to use offshore factoring to repatriate low-taxed foreign earnings in the following manner: Assume that a U.S. corporation (parent) has a foreign subsidiary (sub A) with low-taxed foreign earnings that it wishes to repatriate. Parent forms a second foreign subsidiary (sub B) that borrows money from sub A which sub B uses to factor parent's receivables. Sub B pays interest to sub A at an arm's-length rate. Sub B is engaged in the conduct of a trade or business in the United States, and files a U.S. income tax return on which it reports its factoring income. Sub B distributes its income to parent as a dividend. Parent is allowed an 85-percent dividends-received deduction on such dividends. Most of sub B's U.S. taxable income is eliminated by the interest payment to sub A. The purpose of this structure is a distribution of sub A's earnings to parent at a maximum rate of 6.9 percent (46 percent x (dividend minus the 85 percent deduction)). It is unclear whether this structure yields the tax result the U.S. parent seeks (*see* Rev. Rul. 76-192, 1976-1 C.B. 205).

Reasons for Change

The committee will not condone artificial devices that shift income out of U.S. taxing jurisdiction and into tax havens. Some factoring transactions involve credit sales by U.S. sellers to U.S. buyers. There is no justification for allowing the U.S. seller to shift part of the income from this wholly domestic transaction outside the United States to a passive, related party in a tax haven.

Similarly, if a foreign corporation controlled by U.S. shareholders sells a receivable to a related foreign corporation, profits may be shifted from a high-tax foreign country to a tax haven. As a result, there could be deferral of current tax on that income, or generation of low-taxed foreign-source income available to absorb otherwise unusable foreign tax credits. If the bill did not apply to this situation, the factoring of receivables from one foreign subsidiary to a related foreign corporation where the discount income is not taxed by the United States or any country would give an advantage to foreign operations of a U.S. business over the U.S. operations of the same business. The committee believes, however, because there is no shifting of income into tax havens when a controlled foreign corporation factors receivables of related corporations that operate in the some country, that it is appropriate to provide an exception for such transactions.

Furthermore, multinational corporations based in the United States are using foreign subsidiaries to factor receivables as a device for repatriating foreign earnings tax-free. The committee is concerned about the recent growth in this offshore factoring and consequent tax-free repatriation of foreign earnings. The committee believes, therefore, that taxpayers should pay tax on foreign earnings repatriated through factoring subsidiaries.

Explanation of Provision

Under the bill, a controlled foreign corporation's income from factoring the trade or service receivables of related parties will be treated as foreign personal holding company income. Thus, when a controlled foreign corporation collects (gets cash for) a receivable that (1) it bought from a related person, and (2) the related person had taken in exchange for inventory (or services), its factoring income will be tax-haven type income, and its U.S. shareholders will be currently taxable on that income (under subpart F). This rule will apply whether the related person is a foreign person or a United States person. Income from factoring where the factor buys receivables from a related person which (1) is created or organized under the laws of the same foreign country under the laws of which the factor is organized and (2) has a substantial part of its assets used in its trade or business located in that same country will not be treated as foreign personal holding income and, thus, will not be subject to current U.S. tax.

Trade or service receivables will mean any account receivable or evidence of indebtedness arising out of the disposition of Code section 1221(1) property (generally inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of trade or business), or the performance of services, by a related person. Related persons are defined as in section 954(d)(3).

In addition, the bill treats certain factoring like loans from controlled foreign corporations to their U.S. shareholders. The bill amends the definition of U.S. property (in sec. 956) to include any receivable generated by a related U.S. person's disposition of inventory (or performance of services). Therefore, the U.S. shareholders of a controlled foreign corporation will be currently taxable on the amount that it paid for the receivable (up to the amount of the foreign corporation's earnings and profits). Furthermore, the committee intends that a loan by a foreign subsidiary to another foreign subsidiary of the same parent, which factors the receivables of the parent, is an investment by the first foreign subsidiary in U.S. property for purposes of section 956. Thus, in the example described above (in the present law section), where sub A lends money to sub B which sub B uses to factor parent's receivables, the loan by sub A would be treated as an investment in U.S. property for purposes of section 956 (*i.e.*, the principles of Rev. Rul. 76-192, 1976-1 C.B. 205 would apply).

Income from factoring the receivable of a related U.S. person will be treated as income from sources within the United States. In addition, any distribution from a foreign corporation (and any amount included in the income of U.S. shareholders under sec. 951) that is attributable to such factoring will be treated as income from sources within the United States.

Effective Date

These provisions of the bill will apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984, in taxable years ending after such date.

Revenue Effect

This provision will increase fiscal year budget receipts by $313 million in 1985, $547 million in 1986 and $590 million in 1987.

2. Taxation of Certain Transfers of Property Outside the United States (sec. 132 of the bill and secs. 367, 1492, 1494, 7477, 7482, and new sec. 6038B of the Code.)

Present Law

U.S. citizens, residents, and corporations are generally subject to tax on their worldwide income. In contrast, the United States generally taxes foreign corporations only on their U.S.-source income and foreign-source income that is effectively connected with a U.S. trade or business. Because of the application of these rules taxpayers can defer U.S. tax on earnings derived through a foreign corporation until the earnings are distributed as dividends or the taxpayer disposes of the shares in the corporation. The advantage of using a foreign corporation to defer U.S. tax is enhanced when the corporation is organized in a tax-haven country that imposes little or no tax on the corporation's earnings.

Certain transfers of appreciated property, in the course of a corporate organization, reorganization, or liquidation, can be made without recognition of gain to the corporation involved or its shareholders. However, except for transfers of stock or securities of a foreign corporation that is a party to the exchange, a foreign corporation is not considered a corporation unless, pursuant to a request filed no later than the close of the 183rd day after the beginning of the transfer, the taxpayer establishes to the satisfaction of the Internal Revenue Service (IRS) that the exchange did not have the avoidance of Federal income taxes as one of its principal purposes (sec. 367(a)). Because corporate status is essential to a tax-free organization, reorganization, or liquidation, the failure to obtain a favorable ruling could result in the recognition of gain realized by the participant corporation and shareholders. This rule prevents the tax-free removal of appreciated assets from U.S. tax jurisdiction prior to their sale.

The types of exchanges subject to post-transaction clearance by the IRS are contributions of property to the capital of a controlled corporation (sec. 351), tax-free corporate reorganizations (secs. 354, 355, 356, and 361), and liquidations of subsidiary corporations (sec. 332). The statute authorizes the Secretary to designate by regulation exchanges, otherwise subject to the ruling requirement, that do not require the filing of a ruling request. However, the Secretary has not yet issued regulations pursuant to this authority.

No ruling is required for exchanges involving foreign corporations that are not treated as transfers out of the United States (sec. 367(b)). Examples of exchanges that do not require rulings are the liquidation of a foreign subsidiary corporation into a U.S. parent (sec. 332) and acquisitions of stock or assets of foreign corporations in exclusively foreign transactions (secs. 351, 354, 355, or 361). With respect to these transactions, a foreign corporation is not treated as a corporation to the extent that the Secretary provides in regulations that are necessary or appropriate to prevent the avoidance of Federal income taxes. The statute contemplates that regulations promulgated with respect to this group of transactions will enable taxpayers to determine the extent, if any, to which there is immediate U.S. tax liability. Pursuant to this statutory authority, temporary regulations have been promulgated under which (i) a notification requirement is imposed and (ii) taxpayers are required to include in income appropriate amounts to reflect realization of gain with respect to certain transactions (Temp. Treas. Regs. sec. 7.367(a)-1 through 7.367(c)).

Internal Revenue Service Guidelines

In 1968, the Internal Revenue Service issued guidelines (Rev. Proc. 68-23, 1968-1 C.B. 821) as to when a ruling ordinarily will be issued that an exchange does not have as one of its principal purposes the avoidance of Federal income tax. The guidelines serve only to implement the principal purpose test of the statute. The determination of whether an exchange has the avoidance of Federal income tax as a principal purpose depends in every case upon the particular facts and circumstances. Thus, the IRS reserves the right to issue an adverse ruling, and a taxpayer is free to establish that a favorable ruling should be issued.[1]

Transfers for use in a trade or business

In the case of an exchange involving the transfer of property (other than certain "tainted assets" described below) to a foreign corporation controlled by the transferor after the transfer (a "section 351 exchange"), a favorable ruling ordinarily will be issued when the transferred property is to be devoted by the foreign corporation to the active conduct of a trade or business in a foreign country. The guidelines contemplate that the foreign corporation, in addition to devoting the property to the active conduct of a trade or business, will have need for a substantial investment in fixed assets in such business or will be engaged in the purchase and sale abroad of manufactured goods.

Tainted assets

Where property falling within any of several categories of "tainted assets" is transferred in a section 351 exchange to a foreign corporation (along with either property to be devoted by the foreign corporation to the active conduct of a trade or business or certain foreign corporate stock) the IRS generally will issue a favorable ruling only on the condition that the transferor agree to include in its gross income an appropriate amount to reflect the realization of income or gain with respect to the tainted assets (the "toll charge"), regardless of whether the transfer is made for use in an active trade or business. The character of the toll charge and any basis adjustments are determined as though the tainted assets were transferred in a taxable exchange. The categories of tainted assets include:

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[1] Later Revenue Procedures and Revenue Rulings have modified and amplified the guidelines (*e.g.*, Rev. Proc. 80-14, 1980-1 C.B. 617). This report's references to the guidelines are to the guidelines as modified and amplified.

(1) Inventory, certain copyrights, and other property described in section 1221 (1) and (3) of the Code;

(2) Accounts receivable, installment obligations, and similar property on which income has been earned, unless the income has been or will be included in the transferor's gross income;

(3) Property to be transferred under circumstances which make it reasonable to believe that its subsequent disposition by the transferee is one of the principal purposes of the transfer;

(4) Property leased or licensed by the transferor to a user (other than the transferee) at the time of the transfer;

(5) Property to be transferred under circumstances making it reasonable to believe that the property will be leased or licensed by the transferee after the transfer; however, in the case of tangible property, a favorable ruling ordinarily will be issued if the leasing of the property will represent an active conduct of a trade or business in the foreign country, the transferee will have a need for substantial investment in fixed assets in such business, and the lessee will not use the property in the United States. (*See* Rev. Proc. 80-14, 1980-1 C.B. 617.)

(6) Certain U.S. and foreign patents, trademarks, and similar intangibles (discussed in more detail below); and

(7), With a limited exception, stock and securities.

Treatment of stock or securities

The guidelines provide an exception to the treatment of stock or securities as tainted assets where (i) the stock is in a foreign corporation organized under the laws of the same foreign country as the transferee, (ii) immediately after the exchange the foreign corporation is 80-percent owned (sec. 368(c)) by the transferee and has a substantial part of its business assets in the country in which the transferee is organized, and (iii) the transferee is 50-percent owned (as defined in sec. 954(d)(3)) by persons who, immediately before the exchange, controlled the transferor. A favorable ruling also ordinarily will be issued where stock of a domestic corporation is acquired in exchange for stock of a foreign corporation if immediately after the exchange the shareholders of the acquired domestic corporation do not own (directly or indirectly) more than 50 percent of the total combined voting power of the acquiring foreign corporation. However, a favorable ruling will not be issued under these latter circumstances if the assets of the acquired domestic corporation consist principally of stock or securities.

In *Kaiser Aluminium Chemical Corp.* v. *Commissioner* (76 T.C. 325 (1981), *acq.*, 1982-2 C.B. 1), the Tax Court, in overturning an adverse ruling based on the rule that stock is generally a tainted asset, cited the special facts of the case and the guideline principle that transfers of tainted assets only generally are denied tax-free treatment.

The facts of *Kaiser* illustrate the difficulty encountered by taxpayers who seek favorable rulings on stock transfers under circumstances not addressed by the guidelines. In the *Kaiser* case, a foreign corporation that supplied raw materials solely to its shareholders was owned 32.3 percent by the transferor-U.S. corporation, 13.8 percent by the transferee-foreign corporation, 12.5 percent by a subsidiary of another foreign corporation that also owned 45 percent of the transferee, and 41.4 percent by two other manufacturers. The transferor's U.S. parent corporation also owned a 45-percent interest in the transferee. There were substantial restrictions on the sale of the stock in the foreign corporation whose shares were transferred, pursuant to a consortium agreement and a general debenture trust deed. Because the transferee faced the loss of valuable development rights (granted by the Australian government) unless it could insure the availability of sufficient raw materials, four percent of the taxpayer's stock (along with the 12.5 percent interest of the transferee's other affiliate) was contributed to the capital of the transferee. The stock transfers increased the amount of raw materials to which the transferee was entitled. Although the IRS acknowledged that the taxpayer's stock interest was indirectly related to its manufacturing operations as a source of supply, and that there were valid business reasons for the transfer, the Internal Revenue Service declined to issue a favorable ruling under the guidelines. *See* LTR. 7744001 (May 9, 1977). In contrast, on the same facts, the Tax Court concluded that the transferred stock interest was akin to a direct interest in producing assets, and that a favorable ruling should have been issued.

Other areas in which a favorable ruling is issued upon inclusion of a toll charge

A favorable ruling also ordinarily will be issued under the guidelines when assets of a domestic corporation are acquired by a foreign corporation in a corporate reorganization (Code secs. 354, 355, 356 and 361), provided the transferor agrees to include in its gross income an appropriate amount to reflect realization of income or gain on those transferred assets whose transfer would precipitate an unfavorable ruling in connection with a section 351 exchange. For example, if a foreign corporation acquires the assets of a domestic corporation solely in exchange for part of the foreign corporation's stock (a type "C" reorganization) and the acquired assets include inventory (a tainted asset), a favorable ruling will be issued (and tax-free reorganization treatment obtained) only if the domestic corporation agrees to include in its gross income a toll charge reflecting the realization of income from the inventory.

Similarly, a favorable ruling ordinarily will be issued when a domestic corporation is liquidated into a foreign parent corporation, provided the domestic corporation agrees to include in its gross income an appropriate amount to reflect realization of income or gain on those transferred assets whose transfer would precipitate an unfavorable ruling in connection with a 351 exchange. In the case of both corporate reorganizations and liquidations into foreign parents, the character of the toll charge and any basis adjustments are determined as though the property were transferred in a taxable exchange.

Treatment of partnerships

The guidelines do not discuss outbound transfers by partnerships or outbound transfers of partnership interests. However, Treasury regulations proposed in 1982 (Prop. Treas. Regs. sec. 1.367(a)-1(b)(3)) provide that a transfer of property by a partnership to a foreign corporation is treated for purposes of section 367 as an indirect transfer of the property by the partners, with each partner transferring the portion of each asset transferred that is attributable to that partner's partnership interest. The proposed regulations do not prescribe the substantive treatment of the transferred assets. Rather, the transferred assets are generally examined under the guidelines standards, e.g., an asset is considered to be tainted if it is an inventory item, leased property, certain stock, etc. The proposed regulations do not distinguish between limited and general partnership interests and do not provide rules for the transfer by partners of their partnership interests.

Use of closing agreements

Some taxpayers have suggested that the IRS should issue a favorable ruling under section 367 when a transferor is willing to enter into a closing agreement with the IRS obligating the transferor to pay tax on any gain from a subsequent disposition of the transferred assets by the transferee within a certain number of years after the transfer. Currently, the Service declines to do so because of the perceived administrative burden of concluding such agreements and possible difficulties in enforcing them.

In the *Kaiser* case, the Tax Court noted with apparent disapproval the unwillingness of the Service in that case to propose a closing agreement with the taxpayer that specified terms and conditions for a transfer of stock subject to section 367. The Court indicated that an agreement by the transferor to pay tax in that case on a subsequent disposition of the stock by the transferee would obviate any principal tax avoidance purpose.

Transfers of intangible assets

Research, experimentation, and development, if successful, generate valuable intangible assets, such as patents and know-how. U.S. tax rules contain tax incentives designed to encourage research, experimentation, and development. For instance, business expenditures to develop or create an asset with a useful life that extends beyond the taxable year is generally required to be capitalized—that is, they are not fully deductible in the current year. However, taxpayers may elect to deduct currently business "research or experimental expenditures" (sec. 174). Taxpayers may also currently claim a tax credit for 25 percent of certain incremental research expenses (sec. 44F). In addition, under temporary legislation enacted in 1981, all research and experimental expenditures paid or incurred for activities conducted in the United States reduce U.S. income (for purposes of the foreign tax credit limitation). This treatment allows some taxpayers to use more foreign tax credits.

Under the guidelines, a toll charge must be included in income in order to obtain a favorable ruling with respect to an exchange involving a transfer to a foreign corporation of a U.S. patent, trademark, or other intangibles for use in connection with manufacturing for sale or consumption in the United States. Thus, the transfer of U.S.-developed know-how to a tax-haven subsidiary for use in manufacturing goods for the U.S. market (a "U-turn") is subject to tax. Otherwise, U.S. owners of know-how could shift income that arose from that know-how offshore.

Similarly, transfers to foreign corporations of U.S. patents, trademarks, and other intangibles for use in connection with a U.S. trade or business are subject to a toll charge under the guidelines. Thus, the U.S. holder of a soft-drink trademark cannot transfer it tax-free to a foreign subsidiary (which could then charge the U.S. transferor a license fee). Otherwise, U.S. owners and users of trademarks could shift income offshore.

Under the guidelines, transfers of foreign patents, trademarks, and similar intangibles for use in connection with the sale of goods manufactured in the United States are subject to a toll charge. This rule also prevents shifting of income outside U.S. taxing jurisdiction.

By implication, transfers of intangibles for use in connection with a foreign trade or business for consumption outside the United States generally may not be taxable under these IRS procedures.[2] Thus, U.S. persons who take advantage of tax incentives for research may transfer the fruits of research (intangibles) to foreign corporations that may use the intangibles free of any U.S. tax.

In addition, some taxpayers have apparently taken the position that the transfer of foreign patents or know-how for use in foreign manufacturing for the U.S. market is not subject to tax under the guidelines.

In the Tax Equity and Fiscal Responsibility Act of 1982, Congress specified the extent to which income from intangibles could escape U.S. tax under the possessions corporations rules, which benefit primarily Puerto Rico. That Act treats transfers of any possession-related intangibles to foreign jurisdictions as having a principal purpose of tax avoidance.

Incorporation of foreign loss branches

A transfer of the assets of a foreign branch of a U.S. corporation to a foreign corporation which otherwise qualifies as a tax-free contribution to the capital of the foreign corporation or as a tax-free reorganization is a transfer of assets from U.S. taxing jurisdiction. Thus, corporate status is denied to the foreign transferee corporation in the absence of an IRS determination that the exchange did not have the avoidance of Federal income taxes as one of its principal purposes.

Where a foreign branches recognizes a loss, that loss can result in a U.S. tax benefit either because it reduces U.S. tax on domestic source income or because it reduces U.S. tax on other foreign income.

Where the branch whose losses have reduced U.S. tax on domestic source income is incorporated the losses are later recaptured through the foreign tax credit limitation (sec. 904(f)). Where the losses had reduced U.S. tax on foreign income the transaction has as its principal purpose the avoidance of Federal income tax (see Rev. Rul. 78-201), 1978-1 C.B. 91). Under IRS procedures these losses are then recaptured to the extent of the gain realized on the exchange (Rev. Rul. 80-246, 1980-2 C.B. 125; Rev. Rul. 82-146, 1982-2 C.B. 84).

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[2] The Internal Revenue Service has frequently issued private letter rulings that such transfers do not have a principal purpose of tax avoidance. See, e.g., LTR 8404026 (October 31, 1983); LTR 8405004 (September 29, 1983); LTR 8405113 (November 4, 1983).

The Tax Court, however, has held that the transfer of the assets of a foreign branch to a foreign corporation did not have a tax avoidance purpose. *Hershey Foods Corp.* v. *Commissioner*, 76 T.C. 312 (1981). In that case, however, the branch losses had not resulted in a tax benefit to the U.S. corporation because the corporation had foreign tax credits that would have eliminated U.S. on foreign income in any event.

Judicial interpretation of the principal purpose test

The Tax Court has interpreted the statute's principal purpose of tax avoidance test as allowing tax-free transfers of appreciated property to foreign corporations unless the exchange is "in pursuance of a plan having as one of its 'first-in-importance' purposes the avoidance of Federal income taxes." *Dittler Bros.* v. *Commissioner*, 72 T.C. 896, 915 (1979). In *Dittler*, a U.S. corporation owned know-how for the production of rub-off lottery tickets. It transferred that know-how for 50 percent of the stock of a corporation organized in the Netherlands Antilles. The Netherlands Antilles corporation, which operated through a subsidiary, was to use that know-how in connection with non-U.S. manufacturing for non-U.S. markets. The other 50 percent belonged to a United Kingdom corporation, which contributed marketing intangibles. Related parties were to do the manufacturing and marketing of lottery tickets for that Netherlands Antilles corporation. The Netherlands Antilles corporation operated through independent contractors and had very little in the way of fixed assets.

The IRS denied the U.S. transferor's request for a ruling that the transfer of know-how did not have as one of its principal purposes the avoidance of Federal income tax. It based its denial on a failure to satisfy the guideline requirement that the transferee devote the assets to the active conduct of a trade or business and that the transferee generally have need for fixed assets in that business. The Service's factual grounds for that denial included (1) the Netherlands Antilles corporation would not engage in any active business; rather, its income would arise from the know-how and other intangibles and rights that it received from related parties; and, (2) the arrangement created a potential for tax avoidance in that income from exploitation of the know-how was diverted to a passive recipient in a foreign tax-haven country.

The Tax Court did not disapprove of the guidelines' active trade or business requirement or the guidelines' fixed asset requirement. It did not reach the question whether transacting business through independent contractors constitutes an active trade or business. The Court found, despite the specific active trade or business standard in the guidelines, that the transfer fell within a more general rule in the guidelines—reflecting the statute's principal purpose test—that a taxpayer is free to establish that based on all the facts and circumstances of his case a favorable ruling should be issued, notwithstanding any contrary statements contained in the guidelines.

The Tax Court concluded that this transfer did not have a principal purpose of tax avoidance. It based that conclusion on several factors, including that: (1) the U.S. transferor's United Kingdom co-owner of the Netherlands Antilles corporation demanded the Antilles location and the form of the transaction, and that (2) that there was a business reason for retention of up to 25 percent of the transferee's profits in the Netherlands Antilles corporation. The Court found insubstantial evidence to support the conclusion that the U.S. transferor "controlled the form and structure of the transaction." Lacking control, the U.S. transferor did not make the transfer in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

Excise tax on certain transfers not subject to section 367

An excise tax generally is imposed on certain outbound transfers of property not described in section 367 when the transferor fails to establish to the satisfaction of the Secretary of the Treasury that the transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax (Code secs. 1491-94). The excise tax generally applies to transfers of property, whether otherwise tax-free or taxable, by U.S. persons (including corporations and partnerships) to foreign corporations, foreign partnerships, and foreign estates and trusts. However, in the case of transfers of property to foreign corporations, the tax applies only to property treated as paid-in surplus or as a contribution to capital.

The excise tax is equal to 35 percent of the transferor's gain which is not recognized at the time of the transfer. But to the extent the transferor immediately recognizes gain on the transfer, the amount against which the tax is applied is reduced.

A transferor may elect to treat a transfer otherwise subject to excise tax as a sale or exchange of the property transferred and to recognize as gain (but not loss) in the year of the transfer the excess of the fair market value of the property over the transferor's adjusted basis for determining gain on the property (sec. 1057). To the extent that gain is recognized in the year of the transfer pursuant to this election, the transfer is not subject to the excise tax, and normal rules will apply to increase the transferred property's basis to the transferee by the amount of gain received. However, since the objective of the excise tax is to prevent a transfer from escaping tax which is in pursuance of a plan having as one of its principal purposes the avoidance of tax, an election which has such a principal purpose is not permitted.

Declaratory judgment procedure

The Tax Reform Act of 1976 established a declaratory judgment procedure allowing taxpayers to litigate in the Tax Court section 367 determinations in actual controversy (Code sec. 7477). Congress established this procedure because the ruling requirement prevented a taxpayer from going through with a transaction and then litigating in court the question of whether tax avoidance was one of the principal purposes of the transaction. While Congress generally approved of the standards applied by the IRS in making rulings, Congress believed that there may have been cases where these standards were inappropriate or were not being correctly applied.

Under the special declaratory judgment procedure, the Tax Court is empowered to review whether an Internal Revenue Service determination as to tax avoidance is reasonable, and whether the conditions imposed in making the determination are reasonable conditions in order to prevent the avoidance of tax.

Any such declaration has the force and effect of a final judgment or decree and is reviewable as such. The Tax Court is required to base its determination upon the reasons provided by the IRS in its notice to the party making the request for a determination. The facts that the IRS and, hence, the Tax Court must base its determination upon are generally those provided by the taxpayer in its ruling request; the IRS can request additional facts not provided in the initial ruling request but ultimately must issue a ruling whether the taxpayer provides them or not. The Tax Court's judgment is limited to a scrutiny of the IRS's determination.

For a petitioner to receive a declaratory judgment from the Tax Court under this procedure, he must demonstrate that he has exhausted all administrative remedies available to him within the Internal Revenue Service. Thus, he must demonstrate that he has made a request to the Internal Revenue Service for a determination and that the Service has either failed to act, or has acted adversely to him, and that he has appealed any adverse determination.

Reasons for Change

The Congress originally enacted the special rules for non-recognition transactions involving foreign corporations (sec. 367) to close serious loopholes. While that provision has generally worked well over the years, a series of Tax Court cases have threatened to weaken it.

First, the provisions apply only to transfers "pursuant to a plan having as one of its principal purposes the avoidance of Federal income taxes" (sec. 367(a)). Interpreting this provision in the case of *Dittler Brothers, Inc.* v. *Commissioner*, the Tax Court referred to a "principal" purpose as being a purpose "first in rank, authority, importance or degree." The implication of the case was that a tax avoidance purpose for a transfer must be greater in importance than any business purpose before section 367(a) will apply to prevent a tax-free outbound transfer of property. This narrow interpretation by the Tax Court of the principal purpose test has caused the Internal Revenue Service difficulty in administering section 367(a) in a way which restricts the types of tax avoidance transfers that the provisions of that section were intended to combat. This restrictive interpretation, with which this committee disagrees, threatens to undermine the utility of section 367, with the result being an incentive for foreign investment. This committee has no intention of condoning such a result.

The bill generally replaces the principal purpose test of present law with an "active trade or business" exception. Generally, a transfer of property by a U.S. person to a foreign corporation in a corporate organization, reorganization, or liquidation will be subject to the section 367 tax rules unless the property is transferred for use by the foreign corporation in the active conduct of a trade or business outside the United States.

Transfers of intangibles

In addition to the general problems associated with judicial interpretations of the principal purpose test of section 367(a), specific and unique problems exist with respect to applying section 367(a) to the transfer by U.S. persons of manufacturing and marketing intangibles to foreign corporations. Under its published ruling guidelines, the Internal Revenue Service generally has issued favorable rulings for transfers of patents and similar intangibles for use in an active trade or business of the foreign transfer corporation. The only exception are transfers of certain intangibles used in connection with a trade or business in the United States or in connection with goods to be manufactured, sold or consumed in the United States. In light of this favorable ruling policy, a number of U. S. companies have adopted a practice of developing patents or similar intangibles at their facilities in the United States. When these intangibles appear ready for profitable exploitation, they are transferred to a manufacturing subsidiary incorporatd in a low-tax foreign jurisdiction (or in a high-tax jurisdiction that offers a tax holiday for specified local manufacturing operations). By engaging in such a practice, the transferor U.S. companies hope to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with a the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitablilty, to ensure deferral of U.S. tax on the profits generated by the intangible. By incorporating the transferee in a low-tax jurisdiction, the U.S. companies also avoid any significant foreign tax on such profits.

Tainted assets

The committee generally approves of the current administrative practice of denying tax-free treatment to exchanges involving outbound transfers of liquid or passive investment assets unless the U.S. tax on the potential earnings from such assets is paid or preserved for future payment. Accordingly, the bill provides that, except as provided in regulations, tax-free treatment will be unavailable for exchanges involving certain assets ("tainted assets").

The bill generally codifies the tainted asset categories described in the IRS guidelines. However, the bill alters these categories in several respects. First, it has come to the committee's attention that stock and securities transferred to foreign corporations are sometimes clearly to be used by the foreign corporations in the active conduct of a trade or business. Accordingly, the bill does not treat stock and securities as tainted assets. All exchanges involving transfers of stock and securities will be tested under the active trade or business exception. Stock will be considered as transferred for use in an active trade or business when transferred under circumstances resembling those existing at the time of the transfer in the *Kaiser* case or under certain other limited circumstances.

Second, two other categories of assets treated as tainted under the guidelines are not so treated under the bill: assets whose sale by the transferee is a principal purpose of the transfer and assets likely to be leased or licensed by the transferee. Similar to the treatment of exchanges involving transfers of stock, exchanges involving transfers of these assets will be tested under the active trade or business exception. Generally, these assets will not be considered to be transferred for use in the active conduct of a trade or business. However, the committee believes that the leasing of transferred tangible assets should not preclude tax-free treatment of the related exchange when the transferee is engaged in the active conduct of a leasing business involving such assets, the transferred assets will not be leased in the United States, and the transferee has a need for a substantial investment in the type of assets transferred.

Third, foreign currency is defined as a tainted asset. The committee understands that foreign currency transfers by U.S. businesses have increased significantly in recent years due to the increased multinationalization of U.S. business and the substitution of floating for fixed exchange rates in 1971. Because of the obvious liquidity of foreign currency, it can easily and quickly be disposed of by a foreign transferee. There should be U.S tax on gains attributable to exchange rate fluctuations.

Goodwill developed by a foreign branch

The committee does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in abuse of the U.S. tax system.

Transfers of partnership interests

The committee believes that a transfer of a partnership interest by the partner to a foreign corporation generally should receive the same tax treatment as a transfer of the partner's pro rata share of the partnership assets. Accordingly, the bill provides that, except as provided in regulations, U.S. persons who transfer partnership interests to foreign corporations in exchanges described in section 367 are to be treated as transferring their pro rata share of the partnership assets. This rule goes beyond the proposed regulations which deem partners to be the transferors of partnership assets for section 367 purposes only when the *partnership* transfers such assets.

Incorporation of foreign loss branches

In cases where a foreign branch has losses that reduce U.S. tax on foreign income there is as much a potential for a double benefit as there is in the case of foreign branches that reduce U.S. tax on domestic-source income. The case of foreign losses reducing domestic income is addressed generally through the foreign tax credit limitation (sec. 904); the case of foreign branch losses reducing only foreign income is not. Thus, without more, a double benefit can be obtained upon the incorporation of a foreign branch that has realized losses.

The committee believes, however, that a double benefit can be prevented under present law because the transfer of a foreign branch that has realized losses can be a transfer for the primary purpose of avoiding Federal income taxes. The committee believes that the IRS position on this issue, as expressed in Rev. Rul. 78-201, is correct policy and is consistent with present law. The Tax Court, in *Hershey*, has taken the contrary, and incorrect view. The committee believes that it is important to clarify the law to prevent future tax avoidance.

The committee is aware that foreign branch losses may offset foreign income that is effectively exempt from U.S. tax by virtue of the foreign tax credit. In that case recapture may not always be appropriate. If the foreign branch of a U.S. person incurs a loss that offsets high-taxed foreign income, that income would be free of U.S. tax anyway under the foreign tax credit.

Ruling requirement and declaratory judgment procedure

The committee understands that standards for the issuance of favorable and adverse rulings have become relatively well-defined through continuing administrative interpretation and practice. The development of such standards, which the bill codifies in part, has imparted a substantial degree of regularity to the ruling process. Given certain facts, taxpayers can predict whether the IRS will issue a favorable or an adverse ruling. The elimination of the principal purpose test, the application of which involves a primarily factual determination, should further increase predictability of result under section 367. At the same time, many taxpayers consider the ruling requirement burdensome, and the requirement has placed a steadily increasing demand on Service resources as outbound transfers have increased in number. The committee believes that the elimination of the principal purpose test renders the ruling requirement unnecessary. Accordingly, that bill eliminates the ruling requirement. Taxpayers will now be able to proceed freely with exchanges involving outbound transfers without advance or post transaction clearance. The exchanges will be either tax-free or will involve the payment of an appropriate toll charge, in accordance with the substantive rules set forth in section 367, as amended by the bill. However, taxpayers planning a transfer subject to section 367 who seek the certainty of tax treatment that a ruling provides may request a discretionary ruling regarding the tax treatment of the transfer.

The special declaratory judgment procedure of present law, under which the Tax Court reviews section 367 rulings and considers ruling requests, was enacted because, under prior law, a taxpayer who received an adverse ruling, practically speaking, could not proceed with the transaction at issue (unless the taxpayer was willing to comply with the ruling and treat the transaction as fully taxable or accept a toll charge as the case may be). The elimination of the ruling requirement means that taxpayers will no longer be prevented from carrying out transactions by rulings which the taxpayers were compelled by law to obtain. The committee believes that the declaratory judgment procedure is no longer necessary in light of the elimination of the ruling requirement. Accordingly, the bill repeals the declaratory judgment procedure for section 367 determinations.

With the elimination of the ruling requirement and the declaratory judgment procedure, there is also eliminated an unintended advantage presently conferred on taxpayers: full control over the nature of the factual evidence upon which an Internal Revenue Service determination or a declaratory judgment determination under section 367 is based. Under the mandatory ruling procedure of present law, the Service must issue a ruling based on whatever facts the taxpayer provides. The Service can request additional information but cannot compel its disclosure. A Tax Court declaratory judgment is generally based in turn on the administrative record and is limited to a declaration of whether the Service acted reasonably. Under the new discretionary ruling procedure, the Service will decline to rule if the taxpayer does not present facts that the Service deems sufficient upon which to base a ruling. Moreover, judicial review of a section 367 determination will involve a trial and full development of a factual record. That factual record will be independent of the existing administrative record. It might include information about the manner in which the exchange at issue was actually carried out (as distinguished from information about the plan for the exchange) and information about how the transferred property was used and whether the transferee disposed of it after the transfer.

So that the Internal Revenue Service will continue to be informed of outbound transfers of property subject to section 367, the bill establishes a notification requirement and a set of penalties for failure to comply with the requirement. Without a mechanism for appraising the Service of outbound transfers like a notification requirement or the ruling requirement of present law, the Service generally would have to depend on audits to detect outbound transfers of property subject to section 367 and any instances of failure to pay tax due on such transfers. Because of the complexity of some corporate income tax returns and some exchanges which corporations carry out, the audit process is not a reliable means of isolating exchanges subject to section 367.

Explanation of Provision

Overview

The bill restructures the rules governing transfers of property outside the United States. Under the general rule, a foreign corporation is not considered a corporation for purposes of determining the extent to which gain is recognized on the transfer. An exception is provided for transfers of property used in the active conduct of a trade or business outside of the United States. Transfers of stock, securities, or partnership interests may qualify for the exception. The bill authorizes the Secretary to designate other transfers that are excepted from the general rule. In addition, the bill imposes a notification requirement with respect to transfers of property outside the United States.

Certain categories of tainted assets (similar to those in the IRS guidelines) are ineligible for the trade or business exception. The exception to the general rule is also inapplicable to the incorporation of certain foreign branches in circumstances where the branch has operated at a loss. Special rules are provided for the transfer of intangibles (e.g., patents, know-how, trademarks or similar items), under which the taxpayer is treated as receiving income over the useful life of the intangible in an amount reflecting reasonable licensing payments.

The principles governing the imposition of section 367 toll charges and the 35 percent excise tax on outbound transfers not covered by section 367 are similar. To preserve the consistency between the toll charge and excise tax rules, the bill makes conforming changes in the excise tax provisions.

General rule

If, in connection with any exchange described in section 332, 351, 354, 355, 356, or 361, a U.S. person transfers property to a foreign corporation, such foreign corporation generally will not, for purposes of determining the extent to which gain will be recognized on such transfer, be considered to be a corporation. As under current law, except to the extent provided in regulations, this rule will not apply to the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization. The term "party to the exchange" as used in this provision includes a party to the reorganization (as defined in sec. 368(b)) and the transferor and transferee in an exchange other than a reorganization.

Exception for property transferred for use in an active trade or business

Except as provided in regulations, the general rule does not apply to any property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business. The committee believes, notwithstanding the failure of *Dittler* to reach the issue, that the activities engaged in by the corporation involved there did not constitute an active trade or business. The committee contemplates that the transfer of goodwill or going concern value developed by a foreign branch will be treated under this exception rather than a separate rule applicable to intangibles. The committee expects that, prior to January 1, 1985 (the effective date of the bill), the Secretary will issue regulations prescribing the standards to be used in determining whether property is transferred for use in the active conduct of a trade or business within the meaning of the bill. However, if the Secretary does not issue regulations before January 1, 1985, it is intended that taxpayers will continue to rely on the current IRS practice (as reflected in IRS ruling policy) in determining the existence of an active trade or business.

Treatment of stock or securities

Certain transfers of stock and securities by a U.S. person to a foreign corporation will fall within the active trade or business exception and will, therefore, be free of U.S. tax. The committee believes that transfers of stock resembling that in the *Kaiser* case, discussed above, should fall within the exception under the bill.

The regulations implementing the active trade or business exception are also to specify additional circumstances under which outbound transfers of stock may fall within the active trade or business exception. Generally, additional circumstances which might place a transfer of stock within the exception include substantial ownership by the transferee in the corporation whose stock is transferred, and integration of the business activities of that corporation with the business activities of the transferee. The committee expects, in particular, that a transfer of stock of a foreign corporation which was organized under the laws of the same foreign country as the transferee and which, immediately after the exchange is 80-percent owned by the transferee and has a substantial part of its business assets in the country in which the transferee is organized, normally will fall within the active business exception provided the transferee is more than 50-percent owned by U.S. persons who, immediately before the exchange, controlled the transferor. Unlike most other stock, such stock is not treated as a tainted asset under the present IRS guidelines.

The committee is of the view that when the outbound transfer of stock or securities not registered or traded on any securities exchange and which represent a majority interest in a foreign corporation is at issue, the principles underlying the use of closing agreements could have a beneficial impact both on the transferor's willingness to undertake the transaction, and the Internal Revenue Service's ability to enforce section 367. The committee believes that the Internal Revenue Service should set forth regulations whereby, where appropriate, the IRS would not impose tax on the transfer of such stock, provided the transferor agrees that the stock will not be disposed of by the transferee (or any other person) for a substantial period of time following the year of the transfer. The transferor would be taxed on any income or gain from a disposition of the stock as if the disposition took place in the year of the original transfer at the fair market value of the stock at the time of the original transfer. Thus, interest would be added to the tax for the period from the initial transfer to the subsequent disposition.

The committee understands that enforcement of such regulations could, in some cases, present problems. However, it believes that the burdens of enforcing compliance would not outweigh the benefits of regulations in many cases. To promote compliance, the IRS might require in the regulations, for example, that the transferor certify annually for the 15 years following the transfer that the transferred property is still held by the transferee and to file annually a waiver of the statute of limitations on assessment. In addition, the IRS might require that the transferor furnish sufficient security to ensure that any tax will be paid.

Treatment of property likely to be leased

Certain transfers by a U.S. person to a foreign corporation of property likely to be leased by the transferee foreign corporation will fall within the active trade or business exception. The transfer of tangible property of a type leased by the transferee in the active conduct of a leasing business should generally fall within the exception provided the property transferred is not to be leased in the United States and the transferee has need for substantial investment in the type of property transferred. The committee approves the standards of a 1980 Treasury revenue procedure applicable to transferred property that is likely to be leased. (Rev. Proc. 80-14, 1980-1 C.B. 617).

Assets ineligible for active trade or business exception

Under the bill, the transfer by a U.S. person to a foreign corporation of property falling in any of several enumerated categories of tainted assets, even if for use by the corporation in the active conduct of a trade or business, will not be tax-free, except as provided in regulations. The taxpayer will include an appropriate toll charge in gross income but will otherwise generally get tax-free treatment of an exchange with respect to assets other than the tainted property.

The bill creates a new tainted asset category: foreign currency or other property denominated in foreign currency. "Other property denominated in foreign currency" includes installment obligations, accounts receivables, accounts payable, and other obligations entitling their owner to receive cash payments in other than U.S. dollars. It is the committee's understanding that, under the guidelines, such property (with the exception of accounts payable) has been considered to fall into the general accounts receivable category of tainted assets. The bill also provides a special rule for transfers of intangibles, discussed below.

The following tainted asset categories enumerated in the bill are carried over from the guidelines: (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; (2) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held (a) by a taxpayer whose personal efforts created the property, (b) in the case of a letter, memorandum, or similar property, by a taxpayer for whom the property was prepared or produced, or (c) by a taxpayer in whose hands the basis of the property is determined, for purposes of determining gain from a sale or exchange, by reference to the basis of the property in the hands of a taxpayer described in (a) or (b); (3) installment obligations, accounts receivable (including both trade and service receivables) and similar property; and (4) property that, at the time of its transfer, is leased by the transferor to a person other than the transferee. Thus, the transfer by a U.S. person to a foreign corporation of, for example, inventory property, in an exchange described in section 367, will generally render the entire exchange taxable unless the transferor includes in gross income an appropriate toll charge reflecting the realization of income or gain on the tainted inventory property.

Partnerships

The bill contains a special rule for transfers of partnership interests. Except as provided in regulations to be prescribed by the Secretary, a transfer by a U.S. person of a partnership interest to a foreign corporation in a section 367 exchange is to be treated as a transfer of the U.S. person's pro rata share of the partnership assets. Under this rule, an outbound transfer by a U.S. person of his partnership interest generally will be either tax-free or subject to a toll charge, depending upon whether the transfer of the underlying partnership assets would be tax-free or subject to a toll-charge, respectively. For example, the transfer by a U.S. partner to a foreign corporation he controls of his interest in a general partnership engaged in leasing, some of whose assets are leased to other than the transferee (and are, therefore, tainted assets), will be subject to a toll charge with respect to those leased assets. On the other hand, if the general partnership and the transferee foreign corporation are actively engaged in similar manufacturing and the assets of the partnership are chiefly plant and equipment and are to be used by the foreign corporation in its business, then the transfer will probably come within the active trade or business exception and, therefore, be tax-free.

Under regulations to be prescribed by the Secretary, this special rule will not apply to most transfers of limited partnership investments. Because limited partnership interests frequently represent passive, limited liability interests comparable to stock and securities, the committee believes that limited partnership interests generally should be treated like stock and securities for section 367 purposes. Thus, a transfer of a limited partnership interest to a foreign corporation generally will fall within the active trade or business exception only under the limited circumstances in which a transfer of comparable stock or securities would do so.

Special rules for transfers of intangibles

Except as provided in regulations to be prescribed by the Secretary, transfers of intangible property are treated as transfers made pursuant to exclusive licensing agreements. Intangible property is defined as any (i) patent, invention, formula, process, design, pattern, or know-how, (ii) copyright, literary, musical, or artistic composition, (iii) trademark, trade name, or brand name, (iv) franchise, license, or contract, (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data, or (vi) any similar item, which property has substantial value independent of the services of any individual. This rule applies even the intangible property is transferred along with tangible personal property eligible for the trade or business exception.

In general, upon the transfer of intangible property in a transaction that would otherwise fall within the general rule under the bill, the transferor is treated as receiving amounts that reasonably reflect the amounts that would have been received under an exclusive licensing agreement. Amounts are treated as received over the useful life of the intangible property on an annual basis. The bill provides earnings and profits of the transferee foreign corporation are reduced by the amount of income required to be included in income by the transferor. Any amounts included in gross income by reason of this special rule are treated as ordinary income from sources within the United States.

Incorporation of foreign loss branch

In the case of the transfer of the assets of a foreign branch of a U.S. person to a foreign corporation in an exchange described in section 351, 354, 355, 356, or 361, the bill generally requires imposition of tax on the lesser of (1) any gain on the transfer and (2) the excess of losses (incurred by the foreign branch before the transfer and with respect to which a deduction was allowed to the taxpayer) over the amount of such losses recharacterized as U.S.-source income (under sec. 904(f)). In computing the tax imposed under this rule, the recognized gain is treated as ordinary income from sources without the United States. Under this rule, gain on transfers of goodwill or going concern value would be taxable, regardless of whether such property was developed abroad.

The committee intends that the loss branch recapture rule operate—to the extent possible—independently of other rules imposing tax on transfers of appreciated property to foreign corporations. For example, assume that a taxpayer incorporates a foreign branch that has previously incurred $100 of deductible losses. None of the taxpayer's foreign losses previously reduced U.S. income. In connection with the incorporation of the loss branch, the U.S. transferor transfers to the new foreign corporation (1) tainted assets (such as inventory) with $30 of built-in gain (excess of fair market value over basis) and (2) goodwill worth $90, with a basis of zero. The committee intends imposition of tax on $120—not $100—in this case. If the goodwill in this example were worth $60 (rather than $90) the committee intends imposition of tax on $90.

Excise tax rules

To preserve general consistency between the section 367 toll charge rules and the 35-percent excise tax rules, the bill provides that the excise tax will not apply to a transfer when the taxpayer establishes to the satisfaction of the Secretary that gain should not be recognized on the transfer under principles similar to the principles of section 367. The bill makes conforming amendments in the excise tax provision governing abatement and refund of excise tax. Regulations implementing these provisions are to be promulgated by the Secretary of the Treasury.

Elimination of ruling requirement and repeal of declaratory judgment procedure

The bill eliminates the requirement that taxpayers planning a transfer subject to section 367 obtain a ruling from the IRS regarding the tax treatment of the transfer. Taxpayers may now proceed with exchanges involving outbound transfers without advance or, post-transaction IRS clearance. The exchanges will be tax-free or will involve the payment of an appropriate toll charge, in accordance with the substantive rules set forth in section 367, as amended by the bill.

Taxpayers planning a transfer subject to section 367 who seek the certainty of tax treatment that a ruling provides may continue to request a ruling regarding the tax treatment of the transfer. The issuance of such a ruling will be in the IRS's discretion. Thus, the bill repeals the present law rule that the IRS must issue a section 367 ruling when requested. However, the committee expects that when facts sufficient upon which to base a ruling are provided in a ruling request, the Internal Revenue Service normally will issue a ruling. On the other hand, the committee hopes that the regularity of administrative practice under section 367 and the general codification under the bill of that practice provide sufficient certainty with respect to the tax treatment of exchanges subject to section

367 that in many or most cases taxpayers will not consider a ruling necessary.

The bill also repeals the special declaratory judgment procedure for Tax Court review of section 367 rulings and Tax Court consideration of ruling requests.

Notification requirement

The bill establishes a notification requirement for section 367 transfers and a set of penalties for failure to comply with the requirement. The bill requires a U.S. person who transfers property to a foreign corporation in an exchange subject to section 367 to furnish to the Secretary such information with respect to the exchange as the Secretary may require in regulations. The information is to be furnished at the time and in the manner provided by the regulations. When a U.S. person fails to comply with the notification requirement, the bill generally will impose on that person a penalty equal to 25 percent of the amount of the gain which is realized on the exchange (or which would be realized on the exchange if the exchange were taxable). However, no penalty is imposed if the U.S. person shows that his failure to give notice was due to reasonable cause and not to willful neglect.

The bill extends the general three-year limitation on assessment and collection with respect to any tax imposed under section 367 when a taxpayer fails to give the required notice. The bill provides that in such a case the time for assessment of the tax imposed under section 367 does not expire before the date three years after the date the Secretary is notified. Thus, if a taxpayer fails to notify the Secretary of an exchange subject to section 367, the time for assessment of any tax imposed on the exchange by reason of section 367 continues indefinitely.

Effective Date

The bill applies to transfers or exchanges made after December 31, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $12 million in 1986 and $127 million in 1987.

3. Gain From Sale or Exchange of Stock in Certain Foreign Corporations (sec. 133 of the bill and sec. 1248 of the Code)

Present Law

Gain recognized on the sale or exchange of stock in a foreign corporation by a U.S. person owning ten percent or more of the corporation's voting stock may be treated as a dividend (sec. 1248(a)). This rule is designed to prevent U.S. taxpayers from accumulating earnings free of U.S. tax in a controlled foreign corporation (generally, a foreign corporation more than 50 percent of the voting stock of which is owned by U.S. persons who own ten percent or more of such stock), and then (rather than repatriating the earnings in the form of dividends taxable as ordinary income) disposing of the stock at capital gain rates for a price that reflects the accumulated earnings. The statute recharacterizes gain as dividend income to the extent of the corporation's post-1962 earnings and profits attributable to the period the stock sold was held by the shareholder while the corporation was a controlled foreign corporation.

The Tax Reform Act of 1976 extended the rule for dispositions of stock in a foreign corporation to various nonrecognition transactions involving U.S. corporations. Under the 1976 amendment, a U.S. corporation that disposes of stock in a transaction governed by section 311, 336, or 337 (by distributing the stock as a dividend-in-kind or in the course of liquidation) is required to recognize its pro rata share of post-1962 earnings and profits as dividend income. The amount of dividend income required to be included in the U.S. corporation's income is equal to the difference between the fair market value of the stock and its basis, subject to the post-1962 earnings and profits limitation.

Reasons for Change

The statutory purpose of the provision that recharacterizes gain upon the sale or exchange of stock in certain foreign corporations is to tax the accumulated profits of active foreign corporations upon repatriation. Although section 1248 has generally carried out this policy, it has come to the committee's attention that certain transactions may circumvent the statutory rules. For example, taxpayers have taken the position that section 1248 does not apply if a foreign corporation that is wholly owned by a widely held U.S. corporation issues new shares and pays a small amount of cash in exchange for shares representing a majority interest in the U.S. corporation. If this interpretation is sustained, the shareholders of the U.S. corporation might pay a capital gains tax on the difference between the value of the foreign corporation's stock (plus the cash) and their basis in the stock in the U.S. corporation, but no ordinary income tax would be paid on the accumulated earnings and profits of the foreign corporation at that time. Further, because the transaction would result in the foreign corporation ceasing to be a controlled foreign corporation, earnings accumulated prior to the exchange would be permanently exempt from U.S. corporate tax. The committee is aware that present law is unclear, and intends no inference that the transaction works as described.

In the view of the committee, the ability to avoid ordinary income tax by causing a foreign corporation to engage in a transaction with the shareholders of its U.S. parent corporation would make a mockery of the principle of taxing accumulated earnings and profits of foreign corporations upon repatriation. The committee believes that a U.S. corporation should be required to recognize dividend income upon the acquisition of its stock by its wholly owned foreign corporation, to the extent that the U.S. corporation's ownership interest in the foreign corporation is reduced. This treatment is also appropriate in certain cases where a U.S. corporation owns less than 100 percent of a foreign corporation that is or was a controlled foreign corporation.

Explanation of Provision

Under the bill, if shareholders of a U.S. corporation exchange stock in the U.S. corporation for newly issued stock (or treasury stock) of a foreign corporation ten percent or more of the voting stock of which is owned by the U.S. corporation, the transaction is recast. For purposes of applying section 1248, the foreign corporation is viewed as having issued the stock to the U.S. corporation and the U.S. corporation is treated as having distributed that stock to its shareholders. Under the rules of section 1248 provided in present law, the U.S. corporation is thereby required to recognize dividend income. The amount of dividend income is equal to the difference between the fair market value of the stock received by the shareholders of the U.S. corporation and the U.S. corporation's basis for its stock in the foreign corporation, subject to the post-1962 earnings and profits limitation. Under an amendment to section 959 (relating to the exclusion of gross income of a controlled foreign corporation's previously taxed earnings and profits), provided in another section of the bill, the earnings and profits of the foreign corporation are reduced by the amount of dividend income recognized by the U.S. corporation under section 1248.

The application of the provisions of the bill is illustrated by the following example:

Example.—M, a U.S. corporation, is and always has been the sole shareholder of P, a foreign corporation. P, which was organized in 1959, has previously untaxed post-1962 earnings and profits of $40 million. M, whose shares are widely held, has assets worth $100 million (including P shares representing $40 million of value). In recent years, while profits from M's operations have declined, P's foreign operations have generated substantial income. M has a zero basis in the P stock. In addition, many of M's shareholders have losses in their M stock. M's shareholders transfer all of their stock in M to P in exchange for newly issued P stock representing 90 percent of the total number of outstanding P stock plus a *de minimis* amount of cash. After the exchange, P owns all of the outstanding stock of M, and the former M shareholders own stock of P with a value approximating $100 million. The principal purpose of this transaction was to enable the corporate group to retain and reinvest P's accumulated and future foreign earnings free of U.S. tax. On the basis of public and private rulings issued by the Internal Revenue Service and cases decided under the law in effect prior to enactment of the Internal Revenue Code of 1954, the parties to the transaction could take the position that the former M shareholders acquired all the P stock received by them in exchange for M stock worth $100 million, notwithstanding the fact that P's value was augmented by only $60 million dollars. *See* Rev. Rul. 84-30, 1984-9, I.R.B. 5; Rev. Rul. 57-465, 1957-2 C.B. 250; *Helvering* v. *Schoellkopf*, 100 F.2d 415 (2d Cir. 1938).

The bill taxes the transaction in accordance with its economic substance. The effect of the bill is to treat the excess of the value held by the former M shareholders after the exchange ($100 million) over the amount by which P's value was augmented ($60 million) as if M had distributed P shares equal to that difference ($40 million in the example) to its shareholders. Under the 1976 amendments to section 1248, M would recognize ordinary income of $40 million if the P stock were distributed as a dividend-in-kind or in liquidation. Similarly, under the bill, $40 million is includible in M's income as a dividend.

Effective Date

The provision to apply section 1248 to certain indirect transfers is effective for exchanges after the date of enactment.

Revenue Effect

Negligible.

4. Original Issue Discount and Coupon Stripping—Foreign Investors (sec. 134 of the bill and secs. 871 and 881 of the Code)

Present Law

Background—Foreign investors generally

In general, foreign corporations and nonresident aliens are subject to a flat 30-percent U.S. tax on certain U.S. source income not effectively connected with the conduct of a U.S. trade or business. Effectively connected income is taxed at the rates that apply to U.S. persons. In general, foreign investors are subject to the flat 30-percent tax on U.S. source ordinary income, while their U.S. source capital gains (other than real estate gains) are not taxable. Amounts subject to the 30-percent tax in the hands of foreign investors include amounts received as dividends, rents, salaries, "interest (other than original issue discount as defined in section 1232(b)) . . . and other fixed or determinable annual or periodical gains, profits, and income" (secs. 871(a)(1)(A), 881(a)(1)).

Original issue discount

Corporate and Government obligations

Foreign investors may be able to defer tax on certain original issue discount (OID) on obligations of corporations and governments until disposition of the debt instrument. To the extent that deferral is not available, however, these foreign investors may be subject to the accelerated recognition rules that caused front-end loading of income for U.S. persons prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Although foreign investors are not taxable on "original issue discount as defined in section 1232(b)," this exclusion of OID from interest does not exclude all OID from tax. The tax rules governing OID differentiate between pre-April 1, 1972 issues and post-March 31, 1972 issues (secs. 871(a)(1)(C), 881(a)(3)).

a. Deferral on pre-April 1, 1972 issues

Foreign investors generally defer the 30-percent tax on OID on debt issued before April 1, 1972 until disposition (sec. 871(a)(1)(C)(i)). This result occurs because the Code generally treats foreign investors like U.S. persons holding pre-May 27, 1969 debt (sec. 1232(a)(2)(B)). That is, this OID is not subject to the 30-percent tax until sale, exchange, or surrender at maturity. There is no current taxation on ratable amounts of OID (see S. Rpt. 92-437, 92d Cong., 1st Sess., 1972-1 C.B. 559, 601).

b. Post-March 31, 1972 issues

Foreign investors who acquire debt issued after March 31, 1972, and payable more than 6 months[3] from the date of issue are subject to tax on such debt in three ways.

First, they are subject to tax on the actual interest they receive (on the coupons they clip) (see sec. 871(a)(1)(A)).

Second, when they receive a periodic interest payment (clip a coupon), they are subject to tax on the OID "accrued" between the immediately preceding interest payment and the date of the interest payment in question, but "the total amount withheld is not to exceed the amount of interest paid" (S. Rep. No. 92-437, *supra)* (see sec. 871(a)(1)(C)(iii)).

Third, on sale or surrender, the foreign investor is subject to tax on the OID not previously taxed (secs. 871(a)(1)(C)(ii), 1232(a)(2)(B); S. Rpt. 92-437, *supra*). Therefore, if the foreign investor buys a zero coupon bond and keeps it until maturity, he is not liable for any U.S. tax until that time. Low-coupon discount bonds will yield partial tax deferral.

Obligations of partnerships, etc.

OID on noncorporate debt is taxable no later than the time of disposition. The Internal Revenue Service proposed in 1976 to treat OID on "obligations not issued by a corporation or by a government or political subdivision thereof" like OID on post-March 31, 1972 corporate debt. Proposed Reg. sec. 1.871-7(c)(4)(i). That is, according to the proposed regulation, foreign investors are subject to tax on OID on debt issued by partnerships, individuals and other entities that are not corporations or governments ("noncorporate" issuers) upon receipt of coupon interest to the extent of net after-30-percent-tax interest. Any excess tax is due at the time of disposition.

Coupon stripping

Coupons.—Receipt of an interest payment upon surrender of a stripped coupon is taxable at the 30-percent rate. If the foreign investor can establish basis for the surrendered coupon by showing that he or she had purchased it, he or she should, under normal concepts, reduce the taxable income. The treatment of sale of a stripped coupon before maturity is unclear. Foreign investors are not taxed on OID "as defined in section 1232(b)" (section 871(a)(1)(A)). They are taxed on "interest," however. The increased value of stripped bonds and stripped coupons may not be "OID as defined in section 1232(b)". This additional value may be an "amount received . . . as . . . interest (other than original issue discount as defined in section 1232(b)" on which such investors are subject to tax.[4]

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[3] These persons pay no tax on OID on debt payable 6 months or less from the issue date. This result was deliberate. S. Rpt. 92-437, supra.

[4] Arguably, it is instead "other fixed or determinable annual or periodical income" subject to tax. *Cf.* Subcommittee on OID of the N.Y. State Bar, "Taxation and Withholding for OID Realized by Nonresident, Aliens and Foreign Corporations," 25 Tax Lawyer 201, 213 (1972), arguing, prior to the 1972 statutory changes, that much OID was such income.

If sale of a stripped coupon resulted in capital gain for U.S. persons,[5] however, a similar sale by a foreign investor may not be taxable under the general rule that foreign investors pay no tax on capital gains.

Bonds.—Surrender of a stripped bond at maturity or sale of such a bond may generate an "amount received . . . as . . . interest (other than original issue discount as defined in section 1232(b)" or "other fixed or determinable annual or periodical income," either of which would be subject to the U.S. 30-percent withholding tax. This treatment would parallel the treatment of stripped coupons, discussed above. Surrender of a stripped bond at maturity or sale of such a bond is free of tax to the extent that the gain was capital.

Reasons for Change

In connection with its reforms of the tax rules governing income that U.S. persons earn from original issue discount debt and from stripped bonds and coupons, the committee believes that it should conform and clarify the analogous rules governing foreign investors. The committee intends to correct technical problems with these rules. In the case of OID, some of these technical problems have existed since the Revenue Act of 1971. In addition, the TEFRA reforms of the OID and coupon stripping rules did not specifically apply to foreign investors.

The Code does not define "accrual" of OID for purposes of the sections taxing foreign persons. The General Explanation of TEFRA indicates that Congress intended that this "accrual" for post-July 1, 1982 issues be calculated under the TEFRA's new non-front-end loaded method applicable to U.S. persons. In addition, present law is unclear about treatment of OID obligations of noncorporate issuers. Present law may also distinguish between OID obligations that are capital assets and those that are not. The committee believes that clarification of these OID rules is in order.

In addition, the provisions taxing foreign investors do not refer to the Code's coupon-stripping rules (sections 1232A and 1232B). The TEFRA provision treating the discount from face value on the purchase of a stripped instrument as OID has no specific statutory counterpart for foreign investors. The committee has sought to clarify the coupon-stripping rules that apply to foreign investors. In general, the committee conforms these rules to those governing U.S. investors, but has continued deferral of inclusion for foreign investors until surrender of the stripped instrument.

The committee recognizes that this legislation does not end mismatching of (1) an accrual basis U.S. OID debt issuer's tax deductions and (2) a foreign investor's income inclusion. The committee believes that an end to such mismatching would be desirable, but that current inclusion of OID income of foreign investors might present practical enforcement problems. The committee believes that further study of current inclusion is in order.

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[5] Certain sales of stripped coupons before maturity arguably yielded capital gains treatment (see Rev. Rul. 54-251, 1954-2 C.B. 172). Such sales could have yielded interest income, however.

Explanation of Provisions

Original issue discount

When a nonresident alien individual or a foreign corporation receives an interest payment on an OID obligation, an amount equal to the OID accrued on the obligation since the last payment of interest thereon will generally be subject to U.S. tax. However, such OID shall be taken into account for this purpose only to the extent that the tax on the OID does not exceed the interest payment less the (30-percent or lower treaty rate) tax imposed on the interest payment. The bill thus makes it clear that the entire amount of the interest payment may be used to satisfy U.S. income tax. On the sale, exchange, or retirement of an OID obligation, the amount of any gain not in excess of the OID accruing while the foreign investor held the obligation is subject to tax (to the extent that such discount was not theretofore taken into account upon a payment of interest). These rules will apply to OID regardless of whether the instrument is a capital asset in the hands of its holder, regardless of the period that the foreign investor holds it, and regardless of the identity of the issuer.

As under present law, the bill generally defines original issue discount to mean any bond or other evidence of indebtedness having original issue discount. Generally, original issue discount means the difference between the issue price and the stated redemption price at maturity (proposed sec. 1273). That term does not include, however, any obligation payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer) or any obligation that is tax-exempt under section 103 or under any other provision of law without regard to the identity of the holder.

The bill determines the amount of the OID which accrues during any period under the new rules generally applicable to U.S. persons (proposed sec. 1272) or under the corresponding provisions of prior law. Thus, for example, with respect to instruments issued after July 1, 1982, OID generally accrues on the basis of a constant interest rate. As for debt issued by natural persons, however, OID accrues on the basis of a constant interest rate only for post-March 1, 1984 issues. For debt issued before July 2, 1982, OID accrues on a front-end loaded basis.

Except to the extent provided in regulations prescribed by the Secretary, the determination of whether any amount taxable under this OID provision is from sources within the United States is to be made at the time of payment (or sale or exchange) as if the payment (or sale or exchange) involved the payment of interest. The committee has provided regulatory authority because the bill's general source rule may not always produce the proper source of OID income. For instance, an obligor issues a 20-year zero-coupon bond to a foreign investor. For 19 of the 20 years of the bond's term most or all of any interest that the obligor pays would be U.S.-source interest. In the twentieth year, interest that the obligor pays would be foreign-source interest (because, for example, the obligor is an individual who has changed his or her residence or a corporation whose income is no longer effectively connected with a U.S. trade or business). The committee anticipates that regulations could provide that the bulk of the income that arises from the OID in this case is U.S.-source income.

Stripped instruments

The bill provides that the rules treating stripped bonds and stripped coupons purchased after July 1, 1982, as obligations with original issue discount in the hands of U.S. persons (proposed sec. 1286) shall apply to foreign investors. Thus, foreign investors will generally treat stripped coupons and stripped bonds acquired after July 1, 1982 as OID instruments. This treatment generally conforms the treatment of foreign investors to that of U.S. investors, except that foreign investors are not subject to tax until actual receipt of payment.

Effective Date

The bill will generally apply to payments made on or after the 60th day after the date of enactment with respect to obligations issued after March 31, 1972. As noted in the discussion of present law, the bill does not affect the computation of the accrual of OID of pre-July 2, 1982 debt, and it does not affect stripped instruments acquired before July 2, 1982.

Revenue Effect

These provisions will have a negligible effect on revenues.

5. Limitation on Cover Over (Payment) of Certain Federal Excise Taxes to Puerto Rico and the Virgin Islands (sec. 135 of the bill and sec. 7652 of the Code)

Present Law

Present law imposes a special excise tax on articles coming into the United States from Puerto Rico or the Virgin Islands. The tax is equal to the Federal excise tax that would be imposed if the articles had been manufactured in the United States (sec. 7652). This tax is in lieu of the excise tax that would be imposed if the articles had been manufactured in the United States or imported from another country.

Revenues collected from the tax on articles coming into the United States from Puerto Rico or the Virgin Islands are covered over (paid) to the treasury of the possession from which the article comes. No restrictions are imposed on the use of these revenues by Puerto Rico or the Virgin Islands.

The Government of Puerto Rico presently sponsors a redistillation program under which spirits originally distilled in the United States are transported to Puerto Rico and redistilled in that possession. Following redistillation the spirits are returned to the United States for processing and marketing. As a result of their redistillation in Puerto Rico, the Puerto Rican Government receives a payment of $10.50 per proof gallon with respect to these redistilled spirits (i.e., the amount of excise tax presently imposed on distilled spirits) because redistillation is considered to be Puerto Rican production.

Reasons for Change

The committee believes that payment of Federal excise tax revenues to Puerto Rico and the Virgin Islands should be made only with respect to articles having a substantial economic nexus with those possessions. The committee believes that Federal excise tax revenues should not be diverted with respect to activities having little or no economic substance other than collection of a subsidy from these taxes. The redistillation program presently sponsored by Puerto Rico involves a process that likely would not occur without (1) the availability of Federal excise payments to Puerto Rico, and (2) the availability of subsidies by Puerto Rico to participants in the redistillation program. Accordingly, the committee bill limits these Federal excise tax payments to spirits originally distilled in Puerto Rico or the Virgin Islands. The bill also includes additional rules to prevent new programs designed primarily to produce Federal excise tax payments for those possessions.

Explanation of Provision

The committee bill limits the articles with respect to which Federal excise taxes are paid to Puerto Rico and the Virgin Islands to articles satisfying certain tests.

Original distillation test

Under the bill, articles containing distilled spirits coming into the United States from Puerto Rico or the Virgin Islands qualify for excise tax payments only if at least 90 percent of the spirits in the article is originally distilled in those possessions. The committee understands that cover overs of excise taxes are determined under present law at the time an article enters the United States. The committee further understands that this determination is not affected by any change in the character of the spirits after entry into the United States. Therefore, the full cover over will be available on distilled spirits satisfying the 90-percent test upon entry into the United States even if these spirits are subsequently blended with other distilled spirits into an article not satisfying the bill's requirements. However, if such blending occurred before entry into the United States, the cover over would be denied.

Value-added test for articles from Puerto Rico

Under the bill, cover overs of excise tax revenues are permitted with respect to any article (including distilled spirits) coming into the United States from Puerto Rico only if at least 50 percent of the value of the article at the time it comes into the United States is attributable to Puerto Rican input. The items that are considered in determining Puerto Rican input are labor and materials costs and direct costs of processing operations. Direct costs of processing operations include those costs that are considered under section 213 of the Caribbean Basin Initiative Act. As under the original distillation test, modification of any article subsequent to the time it is brought into the United States, is not considered when determining the value of the article or the percentage of the value attributable to Puerto Rican input.

Federal excise tax subsidy prohibition

Under the bill, no cover over of Federal excise tax revenues is permitted for any article (including distilled spirits) if Puerto Rico or the Virgin Islands provides a direct or indirect subsidy with respect to the article unlike subsidies provided with respect to articles not subject to Federal excise tax. A subsidy is unlike other subsidies if it is (1) of a different kind or (2) in a larger amount per value or volume of production. For example, a cover over is not permitted if the cost of raw materials is subject to price guarantees for a product subject to excise tax when the price of raw materials generally is not guaranteed to manufacturers. Slight variations may exist in otherwise comparable subsidies; therefore, the committee anticipates that the Treasury Department will issue regulations prescribing ranges of allowable differences (i.e., "safe harbors").

Special rule for certain cane neutral spirits

The bill generally exempts cane neutral spirits that are originally distilled in Puerto Rico from the value-added requirement and the Federal excise tax subsidy prohibition; cane neutral spirits that are originally distilled in the Virgin Islands generally are exempt from the bill's prohibition on Federal excise tax subsidies. This exception is limited, however, to cane neutral spirits that are not produced under any program, a significant purpose of which is to generate cover overs of Federal excise tax revenues. To enforce this restriction, the Treasury Department is authorized to terminate payments with respect to cane neutral spirits under section 7652 if Treasury determines that Puerto Rico or the Virgin Islands is conducting such an excise tax-motivated program. In making this determination, the committee intends that the Treasury consider such factors as (1) the degree of subsidy provided by the possession and the relation of that subsidy to cover overs under section 7652, (2) whether the program has economic viability independent of Federal excise tax considerations, and (3) the volume of cane neutral spirits produced by Puerto Rico or the Virgin Islands (as the case may be) before enactment of this provision. This provision is not intended, however, to preclude development or continuation of a program for originally distilling cane neutral spirits in Puerto Rico or the Virgin Islands.

General exception for rum

The restrictions imposed by the bill do not apply to cover over of excise tax revenues derived from rum coming into the United States from Puerto Rico or the Virgin Islands.

Effective Date

These provisions generally apply to articles coming into the United States after February 29, 1984.

A transitional rule permits cover over of revenues from redistilled spirits coming into United States from Puerto Rico after February 29, 1984 and before July 1, 1984, but only to the extent these payments do not exceed the excess of $130 million over the total cover overs received with respect to redistilled spirits after June 30, 1983 and before March 1, 1984.

An additional transition rule permits additional cover overs not exceeding $75 million with respect to redistilled spirits coming into the United States after June 30, 1984 and before July 1, 1985.

Revenue Effect

This provision decreases fiscal year outlays by $149 million in 1985, $240 million in 1986, $260 million in 1987, and $264 million in 1988 and 1989.

6. Source of Transportation Income (sec. 136 of the bill and sec. 863 of the Code)

Present Law and Background

U.S. taxation of U.S. persons

The United States generally taxes the income of U.S. persons[6] whether their income is from U.S. sources or from foreign sources. The United States retains the primary right to tax U.S. income of U.S. persons. The U.S. tax on a U.S. person's foreign income may be reduced by means of the foreign tax credit. Generally, a U.S. person may claim a full, dollar-for-dollar credit for foreign income taxes.[7] The credit may not reduce U.S. tax on U.S. income, *i.e.*, it is limited to the amount of pre-credit U.S. tax on foreign income. (This is known as the foreign tax credit limitation.) Because U.S. tax may be reduced on a U.S. person's foreign income by means of the foreign tax credit, some U.S. persons have an incentive to treat income as arising from foreign sources rather than U.S. sources.

Some U.S. persons have excess foreign tax credits. Excess foreign tax credits arise when the amount of foreign creditable income taxes paid or accrued in a given year exceeds the amount of the taxpayer's foreign tax credit limitation.[8] Excess credits may offset U.S. tax on income of a U.S. person, even though no foreign tax is imposed on the specific income in question, if the U.S. person is able to characterize that income as foreign source rather than U.S. source. This is because the foreign tax credit limitation presently applies on an overall basis to most taxpayers: taxpayers combine income and losses from all foreign operations in all foreign countries to determine their foreign tax credit limitations. This allows taxpayers effectively to credit income taxes paid on income from one foreign country against U.S. tax on income characterized as from other foreign sources, so long as total income characterized as from foreign sources is high enough.[9]

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[6] U.S. persons are U.S. citizens, U.S. residents, U.S. partnerships, U.S. corporations, and, generally, U.S. trusts and estates (Code sec. 7701(a)(30)).

[7] Foreign income taxes include income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country (or possession of the United States).

[8] Excess credits can arise for a variety of reasons, all of which involve the foreign tax credit limitation. Differences between the income-sourcing rules of the United States (whose rules are generally consistent with international norms generally recognized by developed countries) and those of other countries may result in U.S. treatment of income taxed by another country as domestic income for purposes of the foreign tax credit. Timing differences in the reporting of income and deductions under U.S. and foreign tax laws may result in a taxpayer's being unable to utilize some foreign tax credits in a year in which income is reported in a foreign country but not in the United States. Excess credits can arise from differences in the deduction allocation rules of the United States and those of other countries. Domestic losses may reduce worldwide taxable income and pre-credit U.S. tax and, hence, the amount of foreign tax credits that can be used currently. Perhaps most importantly, effective corporate income tax rates in many industrialized countries are higher than U.S. income tax rates.

[9] The alternative to applying the foreign tax credit limitation on an overall basis is applying it on a per country basis. Under this method, the taxpayer determines the foreign tax credit on a

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U.S. taxation of foreign persons

In general, the United States does not tax foreign persons (such as foreign corporations and nonresident alien individuals) on their income from foreign sources. The only foreign source income of foreign persons that the United States taxes is income that is effectively connected with a U.S. trade or business. In contrast, the United States generally taxes foreign persons on U.S. source income. U.S. source income effectively connected with a U.S. trade or business generally is taxed in the same manner and at the same rates to foreign persons as to U.S. persons. Gain or loss of a foreign person from the disposition of a U.S. real property interest is taken into account as if the taxpayer were engaged in a trade or business within the United States and as if the gain or loss were effectively connected with that trade or business. A 30-percent withholding tax generally is imposed on the gross amount of certain passive income such as rents, dividends and interest which is received from U.S. sources by foreign persons and is not effectively connected with a U.S. business.

Because a foreign person's foreign source income generally is not taxed by the United States, foreign persons, like some U.S. persons, generally have an incentive to treat income as deriving from foreign sources rather than U.S sources.

Sourcing of income generally

The Internal Revenue Code provides rules for determining whether income is from U.S. sources or from foreign sources. U.S. source income includes, generally, income from sales of property manufactured in the United States and sold in the United States, income from services performed in the United States, dividends paid by U.S. corporations, and interest paid by U.S. persons (sec. 861). Foreign source income includes, generally, income from the sale outside the United States of property manufactured outside the United States, income from services performed outside the United States, dividends paid by other than U.S. corporations, interest paid by other than U.S. persons, and royalties from the use outside the United States of patents, secret processes, and similar properties (sec. 862). Some income generally is treated as partially U.S. source and partially foreign source. This includes, for example, income from the sale of personal property produced by the seller in whole or in part in the United States and sold outside the United States, and income from the sale of personal property produced by the seller in whole or in part outside the United States and sold in the United States (sec. 863(b)).

Sourcing of transportation income

The Code provides that generally rental income from property located in the United States is U.S. source income and rental income from property located outside the United States is foreign source

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country-by-country basis. Thus, the taxpayer is allowed to take a foreign tax credit for taxes paid to any particular foreign country only to the extent that the taxes paid to that country do not exceed the limitation separately determined for that country.

Both an overall and a per country limitation have been used in the United States. In the Tax Reform Act of 1976, Congress generally repealed the per country limitation.

income (secs. 861(a)(4) and 862(a)(4)). Further, income from transportation or other services rendered partly in and partly outside the United States is partly U.S. source income and partly foreign source income (sec. 863(b)(1)). Treasury regulations (Treas. Reg. secs. 1.861-5, 1.862-1(a)(4), and 1.863-4) and rulings provide more detailed sourcing rules for transportation income.

Under the regulations and rulings, the source of transportation income depends on whether the income is rental income (bareboat charter hire) or transportation service income (e.g., time or voyage charter hire). If the income is rental income, it is foreign source income to the extent allocable to periods when the vessel is outside the United States and its territorial waters (the three-mile limit), whether that voyage is between two U.S. ports or a U.S. port and a foreign port (Rev. Rul. 75-483, 1975-2 C.B. 286). If the income is a payment for transportation services between two U.S. ports or a U.S. port and a foreign port, the income is allocated between U.S. and foreign sources by comparing costs incurred within the United States' territorial limits and costs incurred outside the United States' territorial limits (IRS Private Letter Ruling 8229005, March 30, 1982).

Whether income attributable to transportation of cargo between two U.S. ports (or a U.S. port and a foreign port) is rental income or services income, the income will be mostly foreign source income provided the route of transport lies primarily beyond the three-mile limit. Thus, for example, persons who transport crude oil from Alaska to West Coast points or, by way of the Panamanian pipeline, to East Coast points, may treat income earned from such transportation as deriving from foreign sources to the extent allocable to periods when the transporting vessel was outside the U.S. territorial limit.

Reasons for Change

The committee believes that all transportation income attributable to transportation which begins and ends in the United States (or any of its possessions) should be U.S. source income. That is, the committee believes that the United States should retain the primary right to tax this income. Under the present sourcing rules, carriers operating between points in the United States can obtain predominantly foreign sourcing for transportation income earned from their U.S. routes by routing their vessels or aircraft outside the three-mile limit. The transaction rarely has any connection with any country other than the United States.

Treating transportation income attributable to transportation beginning and ending in the United States as foreign source income increases the foreign tax credit limitation of the carrier and affiliates. If the carrier or its affiliates have excess foreign tax credits as a result of unrelated foreign operations, this increase in the foreign tax credit limitation effectively enables the carrier to use the excess credits to offset all or part of any U.S. tax that should be imposed on the transportation income. Thus, the carrier and its affiliates may pay little or no U.S. tax on the transportation income. The committee does not believe that such income should escape U.S. tax.

Explanation of Provision

The bill provides that all transportation income attributable to transportation which begins and ends in the United States (including, for this purpose, in any possession of the United States) is to be treated as U.S. source income. For these purposes, transportation income is defined as any income derived from or in connection with the use, or hiring or leasing for use, of a vessel or aircraft or the performance of services directly related to the use of such vessel or aircraft. Thus, the bill applies to transportation income attributable to both rentals and the provision of transportation services. Transportation income includes income from transporting persons as well as income from shipping. The bill states that the term "vessel or aircraft" includes any container used in connection with a vessel or aircraft.

Under the bill transportation of oil, for example, from U.S. points to other U.S. points, either directly or by way of the Panamanian pipeline, is transportation "which begins and ends in the United States" and thus, transportation income from such transportation is U.S. source income.

The new sourcing rule is to be applied in accordance with regulations prescribed by the Secretary of the Treasury. Generally, transportation of cargo will not be considered to "begin and end in the United States" (and thus, the new sourcing rule will not cause income from such transportation to be U.S. source income) when, en route to a delivery point elsewhere in the United States, a stop at a U.S. intermediate point is made for refueling, maintenance, loading or unloading of other cargo, or other business reasons, if the transporting vessel or aircraft took on the cargo in a foreign country. Similarly, transportation of cargo will not be considered to begin and end in the United States when it involves transportation from one U.S. point to another intermediate U.S. point where refueling, maintenance, etc., takes place before ultimate delivery of the cargo to a point in foreign country. Repackaging, recontainerization, or any other activity involving the unloading of the cargo at the U.S. intermediate point will not change these results under the sourcing rule provided the cargo is transported to its ultimate destination on the same aircraft or vessel that carried it to the intermediate U.S. point. If the cargo is transported to its ultimate destination on another aircraft or vessel, its transportation between the U.S. points generally will be considered to begin and end in the United States.

Transportation of persons will not be considered to "begin and end in the United States" when, en route to a destination elsewhere in the United States, a stop at a U.S. intermediate point is made for refueling, maintenance, or other business reasons, if the persons begin the trip in a foreign country and do not change aircraft or vessels at the U.S. intermediate point. Similarly, transportation of persons will not be considered to begin and end in the United States when it involves transportation from one U.S. point to an intermediate U.S. point like that just noted en route to the persons' destination in a foreign country provided, again, the persons do not change aircraft or vessels at the U.S. intermediate point. Round-trip travel from the United States to a foreign country by persons is not transportation which begins and ends in the United States under the bill and, thus, the new sourcing rule will not cause carrier transportation income attributable to such round-trip transportation to be U.S. source income.

Effective date

The new sourcing rule for transportation income will apply to transportation beginning after the bill's date of enactment in taxable years ending after that date.

Revenue Effect

This provision will increase fiscal year budget receipts by $14 million in 1984, $39 million in 1985, $51 million in 1986 and $55 million in 1987.

7. Use of Territories To Avoid U.S. Tax on Foreign Investors (sec. 137 of the bill and secs. 881 and 7651 of the Code)

Present Law and Background

Payments of U.S. source interest, dividends, and other passive income to foreign investors are generally subject to a 30-percent U.S. withholding tax. The United States does not impose withholding tax, however, on payments of passive income to corporations organized in Guam or in the Commonwealth of the Northern Mariana Islands. The United States does not tax any U.S. income (either active or passive) of "inhabitants" of the U.S. Virgin Islands. Some taxpayers contend that passive U.S. source income can flow through Guam or Marianas corporations or corporate inhabitants of the Virgin Islands to foreign investors free of U.S. tax and free of significant tax in the possession.

These possessions generally use the Internal Revenue Code as their territorial income tax law by substituting the name of the possession for the words "United States" in the Internal Revenue Code where appropriate to give the law proper effect ("mirror Code"). The United States has an "80-20" source rule that treats interest and dividends paid by a U.S. corporation as foreign source income if less than 20 percent of the corporation's income has a U.S. source. In these possessions, then, application of the "mirror Code" might indicate that interest and dividends paid by a corporation organized in the possession are not possession source income if less than 20 percent of the corporation's income is from sources in the possession. A possession corporation whose sole activity is investing in or lending money to its (non-possession) U.S. affiliate (or to unrelated U.S. persons), according to some taxpayers, would earn only non-possession source income. Therefore, taxpayers have contended that payments of interest and dividends from such a possession corporation to a foreign investor are free of the 30-percent possession withholding tax.

Temporary Treasury regulations and rulings, however, provide that income derived from one of these possessions that is not subject to tax to the recipient in the possession is U.S. source income for purposes of the "80-20" source rule. Under the mirror Code, then, income derived from the United States (such as interest paid from a U.S. corporation to a Guamanian finance subsidiary) that is not subject to U.S. tax to the recipient (because of U.S. rules exempting such income from tax) is possession source income for purposes of applying the 80-20 source rule under the possession's mirror Code. (Temp. Reg. sec. 4a.861-1; Rev. Rul. 83-9, 1983-1 C.B. 126). Under the Treasury Department's interpretation, then, if a Guamanian or Marianas corporation received interest and dividend income from a U.S. corporation, the "80-20" rule does not apply, and the possession must impose a 30-percent withholding tax on payments from the local corporation to the foreign investor. Treasury has applied similar rules to V.I. inhabitants (Rev. Rul. 83-10, 1983-1 C.B. 127).

Reasons for Change

The committee is concerned with the proliferation of conduit entities that purport to shield foreign investors from U.S. tax. The committee particularly opposes artificial devices that purport to shield foreign investors from U.S. tax on direct investment, and that purport to shield foreign investors from U.S. tax on dividends. If successful, these devices could allow foreign investors who buy or invest in U.S. companies a significant tax advantage over U.S. investors.

The committee is aware that some foreign investors seek to use conduit corporations organized outside their home countries, in tax treaty partner countries of the United States, to avoid U.S. tax. For instance, under the current income tax treaty with the Netherlands Antilles, an investor from a country with which the United States has no treaty may lend money to a conduit corporation in the Netherlands Antilles, which would relend to a U.S. corporation, and the United States might collect no tax. The committee understands that the Treasury Department has adopted a policy, to be implemented in current and future income tax treaty negotiations, that would limit treaty benefits to *bona fide* residents of the treaty country. The committee urges the Treasury Department to continue that policy and to insist on such a result in treaty negotiations.

The committee believes that rules that eliminate U.S. tax on payments of passive income to corporations organized in U.S. possessions should not apply to foreign-owned corporations or to corporations that derive a large portion of their gross income from outside U.S. possessions. However, the committee does not wish to alter tax incentives that the possessions extend to U.S. investors.

Explanation of Provision

The bill provides that the 30-percent U.S. withholding tax will apply to payments of U.S.-source interest, dividends, and other passive income, to a corporation created in or organized or under the law of Guam or the Virgin Islands, unless (1) 75 percent or more in value of the stock of the corporation is owned (directly or indirectly) by individuals who are citizens or residents of the United States or of any U.S. possession, and (2) 75 percent or more of the gross income of the corporation is derived from sources within a U.S. possession. The bill will also apply to Northern Mariana Island corporations, because references in the Internal Revenue Code to Guam are deemed generally also to refer to the Marianas, absent expressed intent not to have them apply (Pub. Law 94-241, sec. 601(c)). Thus, for example, payments of U.S.-source interest and dividends to a Guamanian corporation that (1) is owned solely by residents of Guam and (2) derives 90 percent of its gross income from Guam and the Marianas will not be subject to U.S. tax.

The bill specifically repeals, for only the limited case of V.I. corporations that fail either 75-percent test, the rule that the United

States does not tax any U.S. income of V.I. inhabitants. The effect of this repeal extends only to the U.S. withholding tax. Otherwise, that rule remains in effect.

The bill makes it clear that this rule is not "mirrored". That is, the bill does not affect the tax imposed by Guam, the Marianas, or the Virgin Islands (under the "mirror Code") on payments of interest, dividends, and certain other income from possessions sources to U.S. corporations. Such payments from sources in Guam and the Marianas will remain free of tax in those possessions, regardless of the U.S. corporation's owners or the source of its other income. Such payments from sources in the Virgin Islands remain subject to a V.I. tax of up to 10 percent (sec. 934A).

Effective Date

These provisions will apply to payments made after March 1, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $10 million annually.

8. Foreign Collapsible Corporations (sec. 138 of the bill and sec. 341 of the Code)

Present Law

Section 341 generally requires a shareholder's gain on the sale or liquidation of a collapsible corporation to be reported as ordinary income rather than capital gain. However, section 341(f)(1) permits a shareholder to obtain capital-gain treatment on the disposition of stock if the corporation consents to recognize gain on disposition of its noncapital assets when realized. It may be possible to circumvent section 341 by causing a foreign corporation to give a section 341(f) consent under circumstances that render enforcement of the consent impractical (*e.g.* if the foreign corporation ceases to be engaged in a U.S. trade or business and the stock is sold to a foreign person).

Section 341(f)(3) provides an additional exception from the collapsible-corporation rules for certain tax-free corporate organizations, reorganizations, and liquidations, where the corporation makes a section 341(f) consent. This exception may also present opportunities for tax avoidance.

Reasons for Change

The committee does not believe that collapsible corporation tax consequences should be avoided by the making of a consent which, in fact, may have no effect. However, the committee is also concerned about flatly prohibiting foreign corporations from making a section 341(f) consent.

Explanation of Provisions

The bill provides that, to the extent provided in regulations, a foreign corporation is ineligible to make a section 341(f) consent. The bill also provides regulatory authority to limit the application of the exception for certain tax-free corporate transactions.

Effective Date

This provision is effective on the date of enactment.

Revenue Effect

Negligible.

9. Recharacterization of U.S. Income as Foreign Income (sec. 141 of the bill and sec. 904 of the Code)

Present Law

In general, the United States taxes all U.S. income—income that arises within the United States—of "United States persons." The term "United States persons" includes U.S. citizens, U.S. residents, U.S. corporations, and certain estates and trusts. The United States does not always tax all foreign income of United States persons. That is, the foreign tax credit can offset U.S. tax on foreign income, but not on U.S. income. This is the purpose of the Code's "foreign tax credit limitation." The foreign tax credit limitation gives some taxpayers who have excess foreign tax credits an incentive to label income as "foreign" rather than "U.S."

U.S. income includes, generally, dividends and interest paid by U.S. persons. It also includes income from insurance policies that cover risks in the United States. Dividends and interest that a foreign corporation (not doing business in the United States) pays are "foreign" income. However, a pro rata portion of dividends and interest paid by a foreign corporation are U.S. income when half or more of the foreign corporation's gross income over a three-year period is effectively connected with a U.S. trade or business.

Taxpayers can place the "foreign" label on some non-business U.S. income by routing it through a foreign corporation. For example, a U.S. person may own 100 percent of a corporation in a tax haven country. That foreign corporation receives non-business U.S. income—perhaps from lending money to its U.S. owner. There may be little or no U.S. tax on the foreign corporation's income. (Although U.S. persons are fully taxable on U.S. income, non-U.S. persons are not always fully taxable on U.S. income.) The U.S. person later receives a dividend (in this case, a deemed distribution) from the foreign corporation. That dividend is "foreign" income. Therefore, it may escape U.S. tax by increasing available foreign tax credits. This result occurs because foreign taxes from one country can offset U.S. tax on income from another country. That is, high foreign taxes on income from foreign business operations could shelter this tax-haven income from U.S. tax.

In some cases, the Code's anti-tax haven activity rules (subpart F) treat a U.S. person as if it had received a dividend from a controlled foreign corporation. If so, that deemed distribution—even if attributable to U.S. income— is foreign income. It, too, may escape U.S. tax (also by absorbing foreign tax credits).

The committee is aware of two particular tax plans that turn U.S. income into foreign income. In one case, a U.S. taxpayer borrows funds from its controlled foreign corporation. This subsidiary may be a conduit that borrows from lenders on the strength of the U.S. taxpayer's credit worthiness. The U.S. taxpayer pays interest to its subsidiary, and deducts the interest (often, predominantly from U.S. income rather than foreign income). The interest income of the subsidiary is currently taxable to its U.S. owner under the anti-tax-haven rules of the Code (subpart F)—but as foreign (non-interest) income. This foreign income—which may bear a relatively low foreign tax—may absorb enough foreign tax credits to escape U.S. tax fully.

In another case, U.S. taxpayers set up "captive" offshore insurance companies to insure U.S. risks. The income from insuring U.S. risks is normally U.S. income. Although the Internal Revenue Service has ruled that the "insurance premiums" paid by a domestic corporation and its domestic subsidiaries to the parent's wholly owned foreign "insurance" subsidiary are not deductible if the "insurance" subsidiary does not also insure risks of insureds outside its own corporate family (Rev. Rul. 77-316, 1977-2 C.B. 53), the Service has also ruled that amounts paid by a domestic petroleum corporation to a foreign insurance company that provided insurance against certain petroleum industry risks only for its 31 unrelated shareholders and their subsidiaries and affiliates were deductible as insurance premiums. In addition to the fact that the 31 shareholders/insureds of the insurance company were unrelated, the ruling indicated that no one owned a controlling interest and no one's risk coverage could exceed 5 percent of the total risks insured. The ruling concluded that such an arrangement allowed the economic risk of loss to be shifted and distributed among the shareholders who comprised the insured group so that it constituted insurance (Rev. Rul. 78-338, 1978-2 C.B. 107). When such a foreign insurance company pays dividends to its U.S. shareholders, those dividends may be foreign income—even if all the risks that the foreign insurance company covered were U.S. risks.

Reasons for Change

The committee continues to believe that U.S. taxpayers should not pay both full U.S. tax and foreign tax on foreign income. Such double taxation could effectively prohibit U.S. taxpayers from conducting foreign operations. The committee continues to believe that the foreign tax credit, which can offset U.S. tax on foreign income, is the appropriate mechanism to prevent double taxation.

The United States, however, should receive the full U.S. tax (unreduced by foreign tax credits) on income of U.S. persons that arises within the United States. The committee intends to proscribe devices that artificially convert U.S. income to foreign income, or other devices that create artificial foreign income. Such devices circumvent the foreign tax credit limitation and erode the U.S. tax base. They could have the result of making U.S. taxpayers indifferent to high foreign taxes on income that is truly foreign. Such devices for conversion of U.S. income to foreign income pass the cost of high foreign taxes from the U.S. taxpayer to the U.S. Government.

Explanation of Provision

Under the bill, if 10 percent or more of the gross income of any United States-owned foreign corporation (over a three-year period) is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, then any distribution (and any interest payment) made by the U.S.-owned foreign corporation (to the extent attributable to U.S.-source income or effectively connected income) that is received (directly or through one or more entities) by any U.S. person will be treated as U.S. source income. For this purpose, U.S.-owned foreign corporation means any corporation of which 50 percent of the combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock was held directly or indirectly by U.S. persons. This provision applies only for purposes of the foreign tax credit limitation; it does not apply for purposes of the rules that tax foreign persons on income that is not effectively connected with the conduct of a U.S. trade or business.

Effective Date

These provisions will generally apply to distributions (and deemed distributions under Subpart F) and interest payments made by U.S.-owned foreign corporations after the date of enactment to the extent attributable to income received or accrued by such corporations after the date of enactment. However, these provisions will not apply to distributions, deemed distributions, or interest payments to the extent attributable to interest received by U.S.-owned foreign corporations on term obligations entered into before March 2, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $24 million in 1984, $69 million in 1985, $93 million in 1986 and $102 million in 1987.

10. Recharacterization of Interest Income as Dividend Income

(sec. 142 of the bill and sec. 904 of the Code)

Present Law

Many foreign countries do not tax interest that their residents pay to U.S. lenders—including interest that their banks pay to U.S. depositors. Therefore, frequently, U.S. persons can earn foreign interest income free of foreign tax.

The United States' foreign tax credit reduces U.S. tax on foreign income (but not U.S. tax on U.S. income). However, if a U.S. person pays no foreign tax on foreign interest income, the U.S. person generally must pay U.S. tax on that foreign interest income because there is a separate foreign tax credit limitation for interest income. Thus, foreign taxes on non-interest income generally will not offset the U.S. tax on foreign interest income, no matter how high the foreign taxes on foreign non-interest income.[10] This rule preserves the U.S. tax on untaxed interest income of U.S. persons, wherever earned. Its purpose is to remove any tax advantage for lending abroad over lending in the United States. It prevents generation of low-taxed foreign interest income that can absorb excess foreign tax credits.

A U.S. person may circumvent this special rule, however. Instead of lending money and earning interest income directly, a U.S. person may create a foreign corporation that lends money (for example, through a bank deposit) and earns interest income. The U.S. person will generally be treated as receiving income currently in the amount of the foreign corporation's interest income (under the Code's anti-tax haven activity rules (subpart F)). The use of the foreign corporation, however, will convert the character of the interest income to non-interest (i.e., dividend) income. This conversion removes the income from the separate foreign tax credit limitation and allows it to absorb foreign tax credits attributable to non-interest income.

Similarly, a U.S. person may invest in a U.S. corporation (such as a mutual fund) that buys foreign interest-bearing investments. The U.S. corporation's dividends may be foreign income under a special rule that recharacterizes payments from a U.S. corporation as foreign if 80 percent or more of its income is foreign. These dividends, under current law, are able to absorb excess foreign tax credits and thus escape U.S. tax.

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[10] Similarly, foreign taxes on foreign interest income generally cannot offset U.S. tax on foreign non-interest income. In general, the total (U.S. and foreign) tax on a U.S. person's foreign interest income is the higher of the U.S. tax or the foreign tax on foreign interest.

Reasons for Change

Taxpayers with liquid assets can earn interest income either in the United States or abroad. The committee believes that the United States should not encourage U.S. taxpayers to earn interest income abroad. Therefore, the United States should not allow taxpayers to offset U.S. tax on interest income with foreign tax credits on non-interest income. That is, the committee seeks to restore the integrity of the separate foreign tax credit limitation for interest income, and to prevent U.S. taxpayers from using artificial devices to convert interest income into non-interest income.

Current law not only encourages U.S. taxpayers to invest capital outside the United States, it also erodes the U.S. tax base. U.S. taxpayers generally will be indifferent to high foreign taxes that offset U.S. taxes. When taxpayers convert low-taxed foreign interest income to non-interest income they circumvent the foreign tax credit limitation. Then, the U.S. Treasury, and not the U.S. taxpayer, bears the burden of foreign taxes on non-interest income.

Explanation of Provision

The bill provides that, for purposes of the separate foreign tax credit limitation for interest income, a pro rata portion of any distribution by a corporation shall be treated as interest if 10 percent or more of the paying corporation's earnings and profits for the three taxable years preceding the taxable year during which the dividend is paid is attributable to interest income. This separate limitation will apply to such recharacterized interest even though the U.S. distributee is related to the distributing corporation. This rule applies only to 50-percent U.S.-owned foreign corporations and regulated investment companies.

This provision will apply to dividends paid (and deemed distributions under Subpart F) by foreign corporations and by U.S. corporations that pay foreign-source dividends to interest income. The committees intends to disregard tiers of corporations in applying this rule.

Effective Date

This provision will apply to payments and deemed distributions from corporations earning interest after the date of enactment. However, these provisions will not apply to distributions, deemed distributions, or interest payments to the extent attributable to interest received by U.S.-owned foreign corporations on term obligations entered into before March 2, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $10 million annually.

K. Taxpayer Compliance Provisions

1. Promoter Lists of Syndicate Participants (sec. 151 of the bill and new sec. 6111 of the Code)

Present Law

There is no explicit requirement that promoters of syndicated investments sold directly to investors should maintain customer lists. As a result, the Internal Revenue Service may have to rely on its summons authority to obtain such lists when examination of them is considered necessary in the investigation of abusive tax shelter schemes. Some promoters, however, may not keep customer lists.

In other contexts, present law provides means for the Internal Revenue Service to pursue taxpayers who were led into a questionable tax position through the representations of a promoter or other third party. For example, the partnership audit provisions of TEFRA enable the Internal Revenue Service to examine partnership issues in a single proceeding and to make appropriate adjustments in the individual partners' returns automatically. Elsewhere, the Code requires that income tax return preparers retain for 3 years either the returns prepared by them or a list of taxpayers for whom returns were prepared. This provision enables the Service to examine, for example, the returns prepared by a particular person, if it finds a pattern of improper return preparation by that preparer.

Reasons for Change

The committee is concerned that promoters of arrangements in which the investor purchases the investments directly are profiting from the inability of the Internal Revenue Service to examine every return. These promoters know that even if a tax scheme they market is clearly faulty, some investors' incorrect returns will escape detection and many will enjoy a substantial deferral of tax while the Internal Revenue Service searches for their returns and coordinates the handling of similar cases.

The new requirement that promoters of potentially abusive tax activities keep lists of customers and investments will enable the Internal Revenue Service to identify quickly all of the participants in related tax-shelter investments. As a result, taxpayers claiming improper treatment will not escape detection, and investors in similar schemes will receive more uniform treatment.

Explanation of Provision

The bill requires that any person who organizes any potentially abusive tax shelter, or sells an interest in such a shelter, shall maintain a list which identifies each person who was sold an interest in such shelter. The Secretary is given authority to issue regulations that prescribe what information should be included in the list and the manner in which it should be kept, and the list must be made available to the Secretary for inspection on his request.

A potentially abusive tax shelter is defined as any entity, investment plan or arrangement, or any other plan or arrangement which the Secretary by regulation has determined has a potential for tax avoidance or evasion. The requirement to maintain a list will apply to any person who organizes or sells any interest in a potentially abusive tax shelter by holding out the possibility that participation in the scheme will yield tax benefits. Generally, a potentially abusive scheme is one that offers the same sorts of investment as schemes characterized by claims with dubious legal merit that certain deductions, credits, or losses could be employed to reduce the tax liability of income from other sources, or the income could be excluded from taxable income. The concept of tax avoidance or evasion as used in this context does not include the purchase of tax-exempt bonds.

The Secretary is given authority to require that the list contain whatever information he finds to be pertinent. The list must enable the Secretary to identify every purchaser of a given type of investment scheme and the amount invested. To this end, the Secretary may require the promoter to maintain the list by reference to specific characteristics that identify their purported tax treatment. These requirements need not apply with respect to partnership interests or subchapter S share ownership because such arrangements are already subject to special audit rules under the Code. Information must be retained for seven years after it is first required to be listed. If 2 or more persons are required to maintain the same list, the Secretary shall prescribe rules under which the maintenance of one list is satisfactory.

Any promoter who fails to maintain a list that is required under the new provisions of the bill will be subject to a penalty comparable to that imposed on income tax return preparers who fail to maintain required lists. Thus, each failure to retain a record of any particular purchaser of an investment will be subject to a $50 penalty, except when the failure results from reasonable cause and not from willful neglect. The penalty for failure to maintain required promoter lists is subject to a limit of $50,000 for any calendar year. This penalty is in addition to any other penalty provided by law.

Effective Date

The amendments made by this section take effect on the date of enactment.

2. Reporting with Respect to Mortgage Interest Received in Trade or Business (sec. 152 of the bill and new sec. 6050H of the Code)

Present Law

Interest paid on a mortgage is deductible in computing taxable income. There is, however, no requirement that the recipients of such interest provide information with respect to the payment to the Internal Revenue Service.

Reasons for Change

The committee believes that a provision requiring recipients of mortgage interest payments aggregating $600 annually to report the interest received to the Internal Revenue Service (with a copy to the payor) will materially assist the Internal Revenue Service in verifying the accuracy of claimed mortgage interest deductions. Internal Revenue Service studies indicate that a significant percentage of all overstated deductions involves overstatement of interest deductions.

Explanation of Provision

Any person who, in connection with a trade or business, receives $600 or more of mortgage interest payments from any person for the calendar year will be required to file a return that contains the payor's name, address, taxpayer identification number, the aggregate amount of interest received, and such other information as the Secretary may prescribe in regulations. This reporting requirement will go into effect after the Secretary has issued regulations and will apply not only to the person entitled to the interest, but also to persons (such as service companies) who receive interest payments on behalf of another. For this purpose, mortgage interest is any interest on an obligation secured by an interest in real property (including interest payable under a contract for deed) and amounts paid in lieu of interest. A person, for the purposes of this provision, includes any governmental unit that receives mortgage interest payments, but the trade or business requirement does not apply to a governmental unit. In addition, a statement must be furnished to each person for whom a report was made showing the name and address and the aggregate amount of interest received by the person making the return.

The committee decided to require reporting only where the amount of interest aggregates $600 or more because payments of that amount generally are the threshold for reporting requirements in other sections of the Code.

The penalty for failure to make required returns will be similar to that imposed on failures to make other information returns. Thus, the penalty will be $50 per failure, subject to a maximum of

$50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect. If, however, the failure to file is due to intentional disregard of the filing requirements, the penalty is not less than 10 percent of the aggregate amount not properly reported and the $50,000 limitation will not apply.

Effective Date

This new reporting requirement will apply to amounts received after December 31, 1984.

3. Returns Relating to Foreclosures and Abandonments of Security (sec. 153 of the bill and new sec. 6050I of the Code)

Present Law

The acquisition by a creditor of property which served as security for a loan may be a taxable event to both the lender and the borrower. The tax effects vary depending upon whether the loan is thereby discharged in whole or in part, whether the debt was recourse or nonrecourse, whether the acquisition was by way of a foreclosure, sale or abandonment, *etc.*

In general, foreclosure events are treated as sales or exchanges between the parties to the extent of the fair market value in the case of recourse debt, and to the extent of the debt in the case of nonrecourse debt. In addition, the foreclosure or other acquisition by a lender of property which was security for a loan in full or part satisfaction of the loan, or the abandonment of the property, may give rise to discharge of indebtedness income to the borrower if the debt was with recourse. Furthermore, foreclosure, abandonment, or a reacquisition of personal property may create a situation in which recapture of the investment tax credit is required.

Special rules apply with respect to foreclosures, or other acquisitions of security, by thrift institutions and certain reacquisitions by sellers of real property when the seller took back a purchase money obligation.

Reasons for Change

Under present law, there is no reporting requirement designed to encourage consistent treatment by the lender and the borrower on a foreclosure, abandonment or other disposition of property which is security for indebtedness. There is no reporting requirement to encourage the correct treatment of discharge of indebtedness income in recourse debt cases. Thus, gain on foreclosure and other disposition events and discharge of indebtedness income may go unreported. In addition, these events are difficult to detect on audit.

Explanation of Provision

Any person (including the United States or a State) who, in connection with a trade or business, lends money secured by property, must make a return to the Secretary reporting any foreclosure or other acquisition of property in full or partial satisfaction of a debt or debts of $15,000 or more secured by that property. The trade or business requirement does not apply to a governmental unit of the United States or a State. An exception is provided for all consumer loans. A consumer loan is defined as any loan to an individual secured by an interest in tangible personal property which is not held for investment and is not used in a trade or business. In addition, the lender must report the abandonment by the borrower of any property which is security for a loan by the lender when the lender first has reason to know that the property has been abandoned.

The Secretary may provide in regulations that any transfer of the property which secures the indebtedness to a person other than the lender shall be treated as an abandonment of such property. In addition, the Secretary also may prescribe regulations that require reporting with respect to other dispositions of property securing indebtedness.

These reports must include the name, address, and taxpayer identification number of the borrower, the original amount of the debt, the type of security for the debt, the amount of debt satisfied by the acquisition, abandonment or disposition of the security, and the recourse or nonrecourse character of the debt. In each case, a duplicate report must be provided to the debtor by January 31 of the year following the calendar year in which the return was made.

The penalty for failure to make required returns will be similar to that imposed on failures to make other information returns. Thus, the penalty will be $50 per failure, subject to a maximum of $50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect. If, however, the failure to file is due to intentional disregard of the filing requirements, the penalty is not less than 10 percent of the aggregate amount not properly reported and the $50,000 limitation will not apply.

Effective Date

This reporting requirement applies with respect to acquisitions or abandonments after December 31, 1984.

4. Increase in Penalty for Promoting Abusive Tax Shelters (sec. 154 of the bill and sec. 6700 of the Code)

Present Law

Any person who organizes, assists or participates in the organization or sale of any interest in a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement that constitutes an abusive tax shelter and who makes or furnishes (1) a statement with respect to the allowability of any tax benefit by reason of participating in the tax shelter the person has reason to know is false or fraudulent as to any material matter, or (2) a gross valuation overstatement with respect to any matter material to the tax shelter is subject to a civil penalty. Thus, persons subject to the penalty may include not only the promoter of a tax shelter partnership but also any other person who organizes or sells a plan or arrangement with respect to which there are material misrepresentations or valuation errors affecting the tax benefits to be derived from participation in the arrangement.

A matter is material to the arrangement if it would have a substantial impact on the decision-making process of a reasonably prudent investor. A gross valuation overstatement is any statement or representation of the value of services or property which exceeds 200 percent of the correct value of the property or services and which is directly related to the amount of any income tax deduction or credit allowable to any participant.

The penalty for promoting an abusive tax shelter is an assessable penalty equal to the greater of $1,000 or 10 percent of the gross income derived, or to be derived, from the activity. It is not necessary that the purchasing taxpayer relied on the information or that actual underreporting of tax occurred.

The Secretary is given authority to waive all or part of any penalty resulting from a gross valuation overstatement, upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith.

Reasons for Change

The attention of the committee has been drawn to evidence that the 10-percent penalty enacted in TEFRA is inadequate in amount since promoters of tax shelters operate on a large margin.

Explanation of Provision

The bill increases the penalty for promoting abusive tax shelters to the greater of 20 percent of the gross income derived, or to be derived, from the activity, or $1,000. The committee did not increase the $1,000 penalty because, as originally enacted, the $1,000 was intended to be a minimum penalty on small promoters who derive little income from the deals they promote.

Effective Date

The amendments to the promoter penalty will take effect on the date of enactment.

5. Reporting of State and Local Income Tax Refunds Not Required with Respect to Non-Itemizers (sec. 155 of the bill and sec. 6050E of the Code)

Present Law

An information return must be filed with the Secretary with respect to any State or local government income tax refund, credit, or offset aggregating $10 or more during the calendar year which is paid or credited to an individual. These reports are required when amounts are paid over or credited regardless of whether they are taxable to the taxpayer in that taxable year. Thus, an amount paid over or credited is reportable even though it is not taxable because the taxpayer received no tax benefit. Similarly, if an amount is credited to reduce the future liability of the taxpayer, it is reportable once credited even though the liability against which the credit will be taken has not yet arisen. The return required by this provision must report the aggregate amount of any such refund payments, credits, or offsets, and the recipient's name and address. State governments can satisfy their return obligations under this provision through voluntary information exchange agreements with the Internal Revenue Service.

In addition, the provision requires that a statement with respect to each return be furnished to the recipient of the refund, credit or offset during January of the calendar year following the calendar year in which the refund is made or the credit or offset allowed. Under temporary regulations, the Treasury has provided that reporting is not required when the officer making the refund determines that that individual received no Federal tax benefit from the tax payment to which the refund relates.

Reason for Change

The committee has learned that many taxpayers who receive income tax refunds from the State and local governments in whose taxing jurisdiction they reside receive no tax benefit under the Federal income tax because they do not itemize their deductions. These taxpayers employ the zero bracket amount in lieu of itemizing their deductions, and changes in the net amount of State and local government income taxes paid after refunds have no effect on the taxpayer's marginal tax bracket.

The intent of Congress when it adopted this provision in TEFRA in 1982 was to require information reporting about tax refunds taxpayers who deduct State and local government income tax payments on federal income tax returns and thereby reduce their tax liability. Taxpayers who do not itemize deductions do not generally receive a tax benefit from a refund of State or local government taxes.

Explanation of Provision

The provision (sec. 6050E(a)) that requires State and local governments to report income tax refunds is amended to exclude from the reporting requirement refunds paid, or offsets credited, to individuals who do not claim itemized deductions on Federal income tax returns. This amendment of the TEFRA provision is intended to codify the temporary regulations prescribed by the Secretary of Treasury.

Effective Date

This amendment will apply to payments of refunds, and credits and offsets made, after December 31, 1982.

6. Authorization to Disregard Appraisals of Persons Penalized for Aiding in Understatements of Tax Liability (sec. 156 of the bill and new sec. 330 of Title 31)

Present Law

The Secretary of the Treasury may prescribe rules governing the admission of lawyers and accountants to practice before the Internal Revenue Service and may bar individuals from practice if he finds them to be incompetent, disreputable or grossly negligent. Present law does not provide any comparable authority with respect to the appearance of professional appraisers in proceedings at the Internal Revenue Service.

Reasons for Change

The committee believes that professional appraisers who seek to present evidence to the Internal Revenue Service should be subject to the same sort of professional regulation that applies to attorneys and accountants practicing before the Internal Revenue Service.

Explanation of Provision

The Secretary of the Treasury is authorized to bar from appearing before the Internal Revenue Service or the Treasury Department, for the purpose of offering opinion evidence on the value of property or other assets, any individual who has been assessed a penalty under the provisions of section 6701 of the Internal Revenue Code. Thus, an appraiser who aids or assists in the preparation or presentation of an appraisal in connection with the tax laws will be subject to disciplinary actions, if the appraiser knows that the appraisal will be used in connection with the tax laws and may result in an understatement of the tax liability of another person. The Secretary also is given authority to provide that appraisals by an appraiser who has been disciplined shall have no probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service.

Effective Date

The provision will apply to penalties assessed after the date of enactment.

7. Provisions Relating to Individual Retirement Accounts (sec. 157 of the bill and secs. 408 and 6693 of the Code)

Present Law

An individual may deduct amounts contributed to an individual retirement account (IRA). A contribution for a taxable year is considered as having been made on the last day of the taxable year, if the contribution is made not later than the time prescribed for filing the return for the taxable year (including extensions). In the case of a calendar year taxpayer who is not granted an extension in the due date for filing his or her return, this means that a contribution made to an IRA for 1983 may be deducted on the 1983 tax return as long as the contribution is made by April 15, 1984.

The trustee of an individual retirement account or individual retirement annuity is required to report to the Secretary of the Treasury and the individual for whom the IRA is maintained on contributions, distributions and other relevant matters required under regulations issued by the Secretary. The regulations are required to prescribe the time and manner in which the reports will be filed with the Secretary and furnished to the individual.

In the event of a failure to file a report regarding an IRA at the time and in the manner required, the person responsible for making the reports will pay a penalty of $10 for each failure, unless it is shown that the failure to file is due to reasonable cause.

Reasons for Change

The committee has learned that the annual IRA reports are not being filed in the time and manner that is desired. When reports are filed, the information concerning contributions made during the course of a year is stated as a single total and does not distinguish between contributions that may have been made for different years. As a result of these shortcomings, the committee decided to reaffirm the Secretary's authority in present law to require reporting as to each year for which contributions are made and to increase the penalty for failure to file in the manner and by the time required.

Explanation of Provision

Section 408(i) which requires that the trustee of an IRA make required reports is amended to require that the report show both the total amount contributed each year and the taxable years to which the contributions relate.

The penalty for failure to provide reports on individual retirement accounts and annuities is increased from $10 to $50 for each failure.

Effective Dates

The amendment to require that reports indicate the year to which a contribution relates shall apply to contributions made after April 15, 1984, for taxable years beginning after December 31, 1983.

The amendment to increase the penalty shall apply to failures occurring after the date of enactment.

8. Returns Relating to Exchanges of Partnership Interests Where Unrealized Receivables and Other Contributory Shares Are Involved (sec. 158 of the bill and sec. 6050J of the Code)

Present Law

Gain or loss is not recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. The basis of an interest in a partnership that is acquired by a contribution of property to the partnership is the adjusted basis of the property to the contributing partner at the time of contribution increased by the amount of any gain recognized to the contributing partner.

Exchanges of interest in a partnership often involve unrealized receivables and inventory items. The amount of money, or the fair market value of unrealized receivables or appreciated inventory items, received in exchange for all or a part interest in a partnership is considered to be ordinary income realized from the sale or exchange of property.

Reasons for Change

It is difficult for the Internal Revenue Service to carry out effectively its partnership audit activity because partnership returns do not provide sufficient and adequate information concerning the elements (described in sec. 751(a)) in a sale or exchange of property related to partnership interests. The information is needed to determine proper allocation of capital gains or losses and ordinary income. At times, the exchanges of partnership property are also related to tax shelter schemes, some of which might be characterized as abusive tax shelters.

Therefore, the committee has decided to add a new reporting requirement that will relate to exchanges of partnership interests for partnership properties in certain receivables and inventory items.

Explanation of Provision

A partnership will be required to make an information return when there is an exchange of any interest in a partnership in any calendar year for unrealized receivables, inventory items that have appreciated in value, or money. The return shall state the name and address of the transferor and transferee in the exchange, and whatever other information that the Secretary may prescribe in regulations. The Secretary also will describe in regulations the time and manner of the return. In addition, every partnership that files a return required by this section also shall furnish to each person whose name appears on the return the name and address of the partnership and the information shown on the return with respect to that person. The statement shall be furnished to the person on or before January 31 following the calendar year for which the return was made.

Failure to file a return that is required by this section with the Secretary will subject the delinquent person to a $50 penalty for each failure, but a limit of $50,000 is placed on the total amount of penalties imposed on any delinquent person during any calendar year. In the case of intentional disregard of the reporting requirements, the penalty shall be not less than 10 percent of the aggregate amount of the items required to be reported, and the $50,000 limitation shall not apply.

The penalty for failure to furnish a statement to a person with respect to whom a return has been made under this section will be $50 for each statement not furnished to the person, but the limit on the total amount of penalties imposed on a delinquent person shall be $50,000 during any taxable year.

Effective Date

The amendments made by this section shall apply with respect to exchanges that occur after December 31, 1984.

9. Statements Required in Case of Certain Substitute Dividend Payments (sec. 159 of the bill and sec. 6045 of the Code)

Present Law

A broker who holds stock in street name for a customer may lend that stock to another customer for use in a short sale. The short-seller sells the borrowed stock with the expectation that the price of the stock will decline and expects to be able to purchase stock to return to the lending broker at a price below the proceeds of the sale. If a dividend is paid on the borrowed stock, the short-seller must pay the lender an amount in lieu of the dividend. The actual dividend is received by the purchaser in the short sale. If the borrowed stock belonged to a corporate client of the broker, the corporation is not entitled to the dividends received deduction on the amount of the payment received in lieu of the dividend.

Reasons for Change

The committee understands that the inadequacy of the reporting requirements under present law has led to situations in which the dividends received deduction is being claimed twice with respect to the same stock because corporations who have deposited stock with their broker are unaware that the stock has been lent out in connection with a short sale and that the payment they have received is not a dividend but a dividend-substitute payment. The committee decided that a change in broker reporting requirements is needed so that corporate customers of brokers can be informed of the action on the short sale so that they will not take improperly the dividend received deduction.

Explanation of Provision

The Secretary will be authorized to require that any stock broker who lends stock of a corporate customer for use in a short sale, and receives (on behalf of the customer) a payment in lieu of a dividend on such stock during the period the short sale is open, will furnish the corporate customer a written statement identifying the payment as being in lieu of a dividend payment.

The regulations shall prescribe the time and manner for furnishing the statement to the customer.

As a result of the information statement provided to the corporate customer, an improper deduction for receipt of intercorporate dividends will not be taken.

Effective Date

The amendment made by this section shall apply to payments received after December 31, 1984.

10. Revenue Effects of Compliance Provisions

The compliance provisions of the bill are estimated to increase fiscal year budget receipts by $20 million in 1985, $92 million in 1986, $175 million in 1987, $232 million in 1988, and $255 million in 1989.

L. Miscellaneous Provisions

1. Inclusion of Tax Benefit Items in Income (Sec. 161 of the Bill and sec. 111 of the Code)

Present Law

Under present law, a taxpayer who recovers an item for which a deduction was claimed in a prior tax year must generally recognize income if the deduction resulted in a reduction in taxes in the earlier year. Under the judicially-created tax benefit rule, the taxpayer takes into income in the year of recovery an amount equal to the portion of the deduction that produced a tax benefit. Correspondingly, the taxpayer excludes from income an amount equal to the portion that did not produce a tax benefit. The rationale of the tax benefit rule is that the taxpayer should be put in more or less the same after-tax position as if only the proper amount had been deducted.

The tax benefit rule has been codified in section 111 as to recoveries of bad debts, taxes, and delinquency amounts previously deducted. If a previously-deducted amount is recovered, section 111 permits a "recovery exclusion" from gross income for an amount equal to the portion of the deduction in the prior year that did not reduce taxes.

Section 111, as amplified by regulations, has the effect of allowing an individual taxpayer to recover on a tax-free basis State taxes and other items deducted as itemized deductions in a prior year up to the amount by which the zero bracket amount exceeds the taxpayer's other itemized deductions for that year.[1] For example, assume that for 1983 a married couple filing a joint return had $3,700 in itemized deductions, of which $500 related to State income taxes paid in 1983. In 1984, they receive a tax refund from the State in the amount of $200. Under present law, the entire $200 would be regarded as a recovery exclusion and would be excluded from gross income.[2]

Reasons for Change

The treatment accorded under section 111 to State income tax refunds and other itemized deductions subject to the zero bracket amount or similar statutory floor fails to reflect economic reality in certain cases. The statute assumes that a taxpayer first recovers the portion (if any) of the amount deducted in the prior year that did not reduce taxable income.[3] The assumption that the first dollars recovered are not those which produced a tax benefit may, in certain cases, be erroneous and produce a windfall to the taxpayer.

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[1] The legislative history of the predecessor of section 111 supports this interpretation. See H. R. Rep. No. 2333, 77th Cong., 2d Sess. 70 (1942); S. Rep. No. 1631, 77th Cong. 2d Sess. 80 (1942).

[2] See Rev. Rul. 79-15, 1979-1 C.B. 80, for examples of the application of section 111 to State tax refunds.

[3] The portion that did not reduce taxable income will be the difference between the taxpayer's other itemized deductions and the zero bracket amount.

Thus, in the above example, the couple claimed excess itemized deductions of $300 in 1983 and reduced their total taxable income by that amount. If they had deducted only those taxes which they actually owed to the State, they would have claimed only $100 in excess itemized deductions ($3,200 other itemized deductions, plus $300 State taxes, less the $3,400 zero bracket amount). By allowing them to recover $200 without tax consequences, the regulations fail to achieve the tax benefit rule's objective of putting taxpayers in roughly the same position as if the "erroneous" deduction had never been taken.

The committee has concluded that the law should be amended to more accurately reflect the tax benefit concept.

Explanation of Provision

The bill amends section 111 to provide that when an amount attributable to a prior year's deduction is recovered, such amount may be excluded from gross income only to the extent it did not reduce income subject to tax. Thus, in the example described above, the $200 recovered in 1984 would be included in gross income in that year.

The bill also provides that where an amount is recovered that relates to a credit claimed in a prior year, the tax shall be increased by the amount of the credit attributable to the recovered amount (but only to the extent the credit reduced the amount of the tax). This provision will not apply with respect to any amount for which a credit was allowed under the foreign tax credit or investment tax credit provisions of the Code since the treatment of such amounts is governed by existing provisions of the Code and regulations.

As under present law, an increase in a carryover which has not expired will be treated as reducing income subject to tax or as reducing the amount of tax.

Effective Date

The provision will apply to amounts recovered after December 31, 1983, in taxable years ending after that date.

Revenue Effect

It is estimated that the provision will increase fiscal year budget receipts by $229 million in 1985, $255 million in 1986, and $274 million in 1987.

2. Below-Market and Interest-Free Loans (Sec. 162 of the bill and sec. 7872 of the Code)

Present Law

Transfers of Income Other Than By Interest-Free or Below-Market Interest Rate Loans

Direct assignments of income

It is well established that investment income is taxed to the owner of the income producing property, even if the owner of the property makes a gift of the right to receive the income prior to receipt of the income. The underlying rationale for this rule is that the owner of the property realizes the income upon the exercise of control over its disposition. *Helvering* v. *Horst*, 311 U.S. 112 (1940). Further, an assignment involves a taxable gift by the assignor to the assignee which occurs at the time of the assignment. In such case, the amount of the gift is the value of the amount received by the donee.

For example, if a cash method taxpayer detaches coupons from a bond and gives them to his or her son, without receiving fair value in exchange, and the son receives the interest represented by the coupons, the interest income would be included in income by the parent donor under the principles of *Horst*. In addition, the donor would be treated for gift tax purposes as having made a gift to the son in an amount equal to the value of the interest income to be received by the son.

Transfers of income-producing property to trusts

In general, the income of a trust is taxed to the trust to the extent that it is retained by the trust or is taxed to the trust's beneficiaries to the extent that the trust's income is distributed to its beneficiaries. However, under Code sections 671-679, a transferor of property to a trust (a "grantor") is treated as the owner of the transferred property for Federal income tax purposes if he retains certain powers over, or interests in, the trust. In such event, income, deductions and credits of the trust are attributed directly to the grantor.

Under section 676, a grantor is treated as the owner of a revocable trust. In addition, under section 673(a) a grantor is treated as the owner of all or a portion of a trust in which he has a reversionary interest in either corpus or income if, as of the inception of that portion of the trust, the grantor's interest will, or may reasonably be expected, to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust. For example, if a grantor were to transfer $50,000 to a trust, and the trust agreement were to provide that (1) the income would be distributed annually to the grantor's son, (2) the trust would terminate after eight years, and (3) at termination, the trust corpus would be returned to the grantor, the grantor would be treated as the owner of the trust and the income generated by it would be taxed to the grantor.

For gift tax purposes, a transfer of property to a trust is a taxable gift from the grantor of the trust to the trust's beneficiaries in the amount of the value of the beneficiaries' interests in the trust. A transfer to a trust results in a taxable gift to the extent of the value of the beneficiaries' interest in the trust regardless of whether the grantor is treated as the owner of the trust under the grantor trust rules. In the example set forth above, the grantor would be treated as having made a taxable gift to his or her son in an amount equal to the value, determined at the time of the transfer to the trust, of the right to the use of $50,000 for a period of eight years.

Demand or term loans to family members

Under present law, an interest-free or below-market interest rate loan from one family member to another results in a gift from the lender to the borrower for Federal tax purposes. *Dickman* v. *Commissioner*, U.S. (1984), 52 U.S.L.W. 4222 (U.S. Feb. 22, 1984). In the case of demand loans, the Internal Revenue Service takes the position that the amount of the gift is the value of the right to the use of the money for "such portion of the year as the [lender] in fact allows the [borrower] the use of the money." Rev. Rul. 73-61, 1973-2 C.B. 408. Under this approach, the amount of the gift is calculable as of the last day of each calendar year during which the loan is outstanding.[4]

In the case of a term loan, the amount of the gift is the excess, at the time the money and note are exchanged, of the amount of money borrowed over the present value of the principal and interest payments required to be made under the terms of the loan. See Rev. Rul. 73-61, supra; Rev. Rul. 81-286, 81-2 C.B. 176; *Blackburn* v. *Commissioner*, 20 T.C. 204 (1953); *Mason* v. *United States*, 365 F. Supp. 670, aff'd 513 F.2d 25 (1975); and *Dickman* v. *United States*, supra.

It is unclear whether, under present law, interest-free or below-market interest rate loans from one family member to another have any Federal income tax consequences. To date, courts have addressed only the gift tax consequences of such transactions.

Loans to employees or shareholders

Demand loans

The Internal Revenue Service has taken the position that, in the case of an interest-free or below-market interest rate loan to an employee or shareholder,[5] the borrower derives an economic benefit that should be included in income for Federal income tax purposes. Under the Service's position, the amount of the income would be the excess of the interest that would have been charged by an independent lender over the interest, if any, that is actually paid under the terms of the loan.

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[4] In *Dickman*, the Supreme Court did not reach the question of the valuation of the gift. In dicta, however, the Court stated that "to support a gift tax... the Commissioner need not establish that the funds lent did in fact produce a particular amount of revenue; it is sufficient for the Commissioner to establish that a certain yield could readily be secured and that the reasonable value of the use of the funds can be reliably ascertained."

[5] Other than a loan to which section 482 (relating to commonly controlled corporations) applies.

Notwithstanding the Service's position, the Tax Court has consistently held that these non-family interest-free or below-market interest rate demand loans do not result in taxable income. In *J. Simpson Dean* v. *Commissioner*, 35 T.C. 1083 (1961), for example, the controlling shareholders of Nemours Corporation borrowed substantial sums of money from the corporation on a non-interest bearing basis. The Internal Revenue Service sought to impute interest income to the borrowers. The Tax Court, however, held that the transactions did not result in income to the borrowers on the grounds that had they "borrowed the funds in question on interest-bearing notes, their payment of interest would have been fully deductible by them under section 163."[6] See also, *Beaton* v. *Commissioner*, 664 F.2d 315 (1st Cir. 1981); *Martin* v. *Commissioner*, 649 F.2d 1133 (5th Cir. 1981); *Suttle* v. *Commissioner*, 625 F.2d 1127 (4th Cir. 1980); *Baker* v. *Commissioner*, 75 T.C. 166, aff'd 677 F.2d 11 (2nd Cir. 1982); *Creel* v. *Commissioner*, 72 T.C. 1173 (1979); *Zager* v. *Commissioner*, 72 T.C. 1009 (1979); *Hardee* v. *United States*, 708 F.2d 661 (Fed. Cir. 1983).

Term loans

The Federal tax treatment under present law of non-family interest-free or below-market interest rate term loans is unclear. In one case, the Tax Court held that shareholders of a corporation, who obtained an interest-free loan from the corporation in order to purchase the corporation's assets, received a distribution of earnings taxable to them as a dividend. Further, the Court held that the amount of the dividend was the excess of the fair market value of the property received over the present value of the taxpayer's note. *Boyd* v. *Commissioner*, 5 TCM (CCH) 791 (1946). But see *Greenspun* v. *Commissioner*, 72 T.C. 931, aff'd 670 F. 2d 123 (9th Cir. 1982).

Loans between commonly controlled corporations

Section 482 provides that, in the case of two or more organizations, trades, or businesses (whether or not incorporated, organized in the United States, or affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses. Treasury regulations under that section provide that where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's-length rate, appropriate allocations may be made to reflect an arm's-length interest rate for the use of the money. The term "arm's-length interest rate" is defined as the rate which was charged, or would have been charged at the time the indebtedness arose, in independent transactions, with or between unrelated parties under similar circumstances. A safe-haven is provided for qualifying loans by a creditor not regularly engaged in the business of making loans or advances of the same type to unrelated parties. Treas. Reg. sec. 1.482-2.

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[6] The Tax Court distinguished this case from the cases involving rent-free use of corporate property by shareholders or officers (C.f., *Alex Silverman* v. *Commissioner*, 28 T.C. 1061, aff'd. 253 F.2d 849 (8th Cir. 1958)) on the grounds that rental payments would not have been deductible in those cases.

Loans in connection with sale or exchange of property

Under section 483, if a contract for the sale or exchange of property provides for deferred payments of part or all of the purchase price, and the deferred payments include unstated interest, a portion of each deferred payment will be treated as interest. Deferred payments include unstated interest if the total of the deferred payments exceed the sum of the present values of such payments plus the present values of any stated interest due under the terms of the contract. Generally, section 483 applies to payments made under a contract for the sale or exchange of property that are made more than six months after the date of the sale or exchange, if at least one payment is due more than one year after the date of the sale or exchange. Section 483 does not apply to contracts with a sales price that cannot exceed $3,000, certain sales or exchanges of patents, and sales or exchanges that result only in ordinary income to the seller.[7]

Reasons for Change

The committee believes that an interest-free or below-market interest rate loan is the economic equivalent of a loan with a market rate of interest required to be paid by the borrower, and a payment by the lender to the borrower to fund the borrower's payment of interest. Further, the committee believes that in many instances the failure to tax these transactions in accordance with their economic substance provides taxpayers with opportunities to avoid a number of tax rules.

Family loans are being used to avoid the assignment of income rules and the grantor trust rules. An interest-free or below-market interest rate family loan involves a gratuitous transfer of the right to use the proceeds of the borrowing until repayment is demanded (in the case of a demand loan) or until the end of the term of the loan (in the case of a term loan). If the lender had assigned the income from the property to the borrower, the assignment of income doctrine would tax the lender on the income. If the lender had transferred the principal amount to a trust established for the benefit of the borrower that was revocable at will (in the case of a demand loan), or that would terminate at the end of a period of not more than 10 years (in the case of a term loan), the income earned on trust assets would be taxed to the lender under the grantor trust provisions set forth in Code secs. 671-679.

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[7] See the provision of the bill which repeals this "ordinary income" exception.

Loans from corporations to shareholders are being used to avoid rules requiring the taxation of corporate income at the corporate level. An interest-free or below-market interest rate loan from a corporation to a shareholder is the economic equivalent of a loan by the corporation to the shareholder requiring the payment of interest at a market rate and a distribution by the corporation to the shareholder with respect to its stock equal to the amount of interest required to be paid under the terms of the loan. If a transaction were structured as a distribution and a loan, the borrower would have dividend income and an offsetting interest deduction. The lender would have interest income. By structuring the transaction as an interest-free loan, the lender avoids including in income the interest that would be paid by the borrower. As a result, the lender is in the same economic position as it would be if it were able to deduct amounts distributed as dividends to shareholders.

Loans to persons providing services from persons for whom the services are provided are being used to avoid rules requiring the payment of employment taxes and rules restricting the deductibility of interest in certain situations by the person providing the services. An interest-free or below-market interest rate loan to a person providing services from a person for whom services are provided resembles, in substance, a loan requiring the payment of interest at a market rate and a payment in the nature of compensation equal to the amount of interest required to be paid under the terms of the loan. In many instances, a transaction structured in this manner would not result in any tax consequences for either the lender or the borrower because each would have offsetting income and deductions. However, there are a number of situations in which the payment of compensation and a loan requiring the payment of interest at a market rate will not offset.[8]

Accordingly, the committee bill recharacterizes interest-free and below-market interest rate loans as arms-length transactions involving (1) a gift, a dividend, or a payment in the nature of compensation, or some other payment in accordance with the substance of the transaction to fund the payment of interest on the loan at a statutory rate; and (2) the payment of interest by the borrower at a statutory rate resulting in income to the lender and a deduction to the borrower. In the case of a demand loan, the gift, dividend, or compensation is deemed to occur annually. In the case of a nonfamily term loan, the gift, dividend, or compensation is deemed to occur at the time that the loan is made.[9] However, the committee believes that there is little difference between term and demand loans between family members. Accordingly, the committee bill treats term loans between family members the same as demand loans for income tax purposes.

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[8] For example, if a taxpayer uses the proceeds of an arms-length loan to invest in tax-exempt obligations, the deduction for interest paid on the loan would be disallowed under section 265. Similarly, in the case of a term loan that extends beyond the taxable year in which it is made, income and deductions will not offset because the compensation income is includible in the year the loan is made.

[9] This treatment is consistent with the treatment of deferred compensation under section 83 which taxes transfers of property in connection with the performance of services when there is no substantial risk of forfeiture. No avoidance of the rules of section 83 are possible in the case of demand loans since, in such cases, the borrower's right to the use of the funds is subject to a substantial risk of forfeiture.

The committee bill provides several exceptions and limitations so that the new rules do not apply to non-abusive transactions. Specifically, the committee is concerned that interest free loans between family members to finance the purchase of consumption items, such as higher education, personal residences, etc., do not result in shifting of income from one family member to another. Accordingly, in the case of a family loan, the committee bill limits the amount of interest income that the lender is deemed to receive to the amount of income of the borrower that is attributable to the interest-free or below-market interest rate loan.

The committee is concerned that it is common for loans to be made from time to time on an interest free basis without any tax avoidance purpose, especially between family members. Generally, the principal amount of these loans is relatively insignificant and they are repaid within a short period. In these situations, the committee believes that there generally are no significant distortions of the taxation of the parties to the loan. Accordingly, the committee bill contains an exception under which the new rules do not apply to a loan if it is established to the satisfaction of the Secretary that tax avoidance is not a principal purpose of the loan.

Explanation of Provision

Overview

Under the bill, interest-free and below-market interest rate loans (referred to as below-market loans) are recharacterized as two arms-length transactions with the parties treated as if:

1. The lender (A) made a gift subject to the gift tax (in the case of a transaction between family members), or (B) paid a dividend includible in income (in the case of a transaction between a corporation and a shareholder) or (C) paid compensation[10] (in the case of a transaction between a person providing services and a person for whom the services are provided), or (D) made some other payment in accordance with the substance of the transaction to fund the payment by the borrower of the interest on a loan from the lender;
2. The lender made a loan to the borrower in exchange for a note requiring the payment of interest at a statutory interest rate (referred to as the "applicable Federal rate"); and
3. The borrower paid interest in the amount of the foregone interest.

The provisions are generally applicable to "below-market loans." Under the bill, a demand loan is treated as as below-market loan if no interest is payable on the loan, or interest is payable at a rate less than the applicable Federal rate. A term loan is treated as a below-market loan if the amount of the loan exceeds the present value of all payments due under the loan. A demand loan is any loan which is payable in full at any time upon the demand of the lender. A term loan is any loan which is not a demand loan.

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[10] For example, if a university makes a demand loan to a professor to help the professor defray relocation expenses and induce the professor to accept an offer of employment from the university, the borrower is treated as having received compensation on the last day of each calendar year during which the loan is outstanding in an amount equal to the foregone interest for such year. Further, the borrower is treated as having paid interest to the lender on such day in an amount equal to the foregone interest for the calendar year. The compensation is included in income by the borrower for the taxable year in which it is treated as received. The payment of interest by the borrower would be deductible under principles generally applicable to the payment of interest.

The provisions apply to family loans and other below-market loans. A family loan is any below-market loan with respect to which the deemed payment by the lender to the borrower is in the nature of a gift.

Timing and amount of transfers

The bill provides different rules for the timing and amount of the transfers described above depending upon whether the loan is a term or demand loan.

Loans other than family loans and demand loans

In the case of any below-market loan other than a family loan or a demand loan, the lender is treated as transferring to the borrower and the borrower is treated as receiving from the lender an amount equal to the excess of the amount of the loan over the present value of all principal and interest payments due under the loan (step 1, above). This transfer is treated as occurring on the date the loan is made. The present value of all principal and interest payments is to be determined under regulations using a discount rate equal to the applicable Federal rate.

The excess of the amount of the loan over the present value of the payments due is treated as original issue discount. As a result, the lender is treated as receiving interest income at a constant interest rate over the life of the term loan. Similarly, the borrower is treated as paying the same amount of interest (step 3, above). The interest which the borrower is treated as paying would be deductible to the same extent as interest actually paid by the borrower.[11]

Family loans and nonfamily demand loans

In the case of a below-market family loan or a below-market demand loan other than a family loan, the lender is treated as transferring to the borrower and the borrower is treated as receiving from the lender an amount equal to the "foregone interest" on an annual basis (step 1, above).[12] In addition, an identical amount is treated being transferred from the borrower to the lender as a payment of interest at the same time (step 3, above). Thus, in the case of a family loan for income tax purposes, the lender is treated as having made a gift to the borrower in an amount equal to the amount of foregone interest. In such event, an amount equal to the amount of the deemed transfer would be included in income by the lender. Generally, such amount would be deductible by the borrower. Except as otherwise provided in regulations prescribed by the Secretary (or in the case of term family loans for gift tax purposes, described below), any amounts of foregone interest attributable to periods during any calendar year are treated as transferred (and retransferred) on the last day of such calendar year.

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[11] No deduction would be allowable for such interest in cases where the borrower did not itemize his deductions for the relevant year or his deductions would be disallowed under other provisions of the Code (e.g., sections 163(d) or 265).

[12] The deemed transfer by the lender to the borrower is treated as (1) a gift, (2) a payment in the nature of compensation, (3) a dividend, or (4) some other payment depending on the substance of the transaction. Further, the tax consequences of these transfers are determined under present law. Thus, in the case of a below-market loan from one family member to another in a transaction in which the lender does not receive any other consideration for the use of its money, the transfer from the lender to the borrower would be a taxable gift. In the case of a demand loan from a closely held corporation to a controlling shareholder, the transfer would be treated as a distribution with respect to the stock of the distributing corporation and be taxed to the shareholder as a dividend to the extent of the distributing corporation's earnings and profits under section 301.

Under the bill, the term "foregone interest" means, with respect to any period during which a loan is outstanding, the excess of (1) the amount of interest which would have accrued on the loan during the period if interest accrued on the loan at the applicable Federal rate, over (2) any interest payable on the loan properly allocable to such period. The committee anticipates that the Treasury Department will prescribe regulations providing for the allocation of interest to each period during which a loan is outstanding.

Amount and timing of transfers in special circumstances

The bill contains a special rule relating to family term loans for gift tax purposes. Under that rule, the amount of the gift is the excess of the issue price of the loan over the present value of all principal and interest payments under the loan. The transfer is treated as occurring on the date the loan is made.[13] In contrast, in the case of a family demand loan, the amount of the gift is the amount of the foregone interest attributable to each calendar year in which the loan is outstanding.

To the extent necessary and appropriate, the bill provides that the Treasury Department may promulgate regulations providing different rules for situations in which the borrower or lender compute taxable income for different taxable years or use different methods of accounting.

Applicable federal rate

Under the bill, the applicable Federal rate is a rate determined by reference to the term of the loan, as set forth below.

Term	Applicable Federal Rate
Less than 3 years	The Federal short-term rate
Over 3 years but not over 9 years.	The Federal mid-term rate
Over 9 years	The Federal long-term rate

The Federal rates are determined by the Secretary within 15 days after the close of 6-month periods ending on September 30 and March 31, respectively, and are to reflect the average market yield during such 6-month periods on outstanding marketable obligations of the United States with comparable maturities. The applicable Federal rate is compounded semiannually.

The determination reflecting the average yield for a 6-month period ending on September 30 is applicable during the 6-month period beginning on January 1 of the succeeding calendar year. The determination reflecting the average yield for the period ending on March 31 is applicable during the 6-month period beginning on the following July 1.

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[13] This is the same rule that is applicable to term loans in nonfamily situations. This is similar to the rule that exists under present law for gift tax purposes, except that the amount of the gift is determined by reference to the applicable Federal rate.

Under the bill, the applicable Federal rate that is used to compute amounts of foregone interest is the rate for the day on which the loan is made. The committee intends, however, that for purposes of computing amounts of foregone interest, a demand loan be treated as a series of one-day term loans. Thus, in the case of a demand loan, foregone interest must be computed on a daily basis. Further, in the case of a demand loan, the applicable Federal rate is always the Federal short-term rate.

Exceptions and limitations

Exception for nontax motivated transactions

The bill provides, that under regulations to be prescribed by the Treasury, this section does not apply to a loan if it established to the satisfaction of the Secretary that the loan does not have as one of its principal purposes the avoidance of Federal taxes. For example, if a father makes a loan to his son on an interest free basis to pay for the son's current educational expenses, the loan will not be considered made for tax avoidance purposes because the son, as a matter of convenience, deposits the loan proceeds in an interest-bearing checking account or demand deposit account to be held for his use during the semester. Further, the committee anticipates the regulations will provide exceptions for occasional transactions involving relatively small amounts that are based on the family relationship and not designed to shift income.

Generally, indebtedness evidenced by (1) deposits at, or (2) investment certificates, withdrawable shares, or repurchasable shares issued by, a bank or savings institution, will not be treated as indebtedness the principal purpose of which is the avoidance of Federal taxes. Similarly, the committee intends that, in general, a loan from an insurance company to an insured with respect to the cash value of the insurance policy will not be treated as a loan the principal purpose of which is the avoidance of Federal taxes. In addition, it is anticipated that Federally subsidized loans such as Federally guaranteed student loans will be excluded.

Special limitations for family loans

In the case of a family loan, the bill limits the amount that can be treated as retransferred by the borrower to the lender to the amount of income, if any, realized by the borrower which is attributable to the loan. Under this rule, a family loan will not result in any income tax consequences if the proceeds of the borrowing are used exclusively for consumption and not for the production of income, and the borrower does not have any net investment income.

If a borrower invests the proceeds of a below-market loan in an interest-bearing savings account, the interest credited to the borrower's account is attributable to the below-market loan. If the borrower acquires income producing securities, amounts received from the securities are attributable to the loan.

The committee anticipates that the Secretary will prescribe regulations that will treat as attributable to a loan income generated by an asset acquired with the proceeds of a loan even if such income is not realized by the taxpayer until after the loan is repaid and the avoidance of Federal taxes is a principal purpose of the transaction. For example, if the proceeds of a loan are used to acquire a deferred annuity and the loan is repaid prior to the annuity starting date, amounts received under the annuity would be treated as income attributable to the loan.

Other exceptions

The bill provides that these rules do no apply to any loan to which sections 483 or 1274 apply.[14]

Regulations

Under the bill, the Treasury is directed to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including (but not limited to) regulations providing that where, by reason of varying rates of interest, conditional interest payments, waivers of interest, or other circumstances, the provisions of this section do not carry out its purposes, adjustments to the provisions will be made to the extent necessary to carry out the purposes of this section. For example, the committee anticipates that regulations may provide that if a loan is made requiring the payment of interest and the interest is cancelled, the lender will have income if the cancellation is in the nature of a gift.

Effective Dates

In general, the provisions of this section apply to term loans made after March 1, 1984, and to amounts outstanding on demand loans after such date. However, a demand loan outstanding prior to March 1, 1984, will not be subject to the provision if it is repaid prior to the 60th day after the date of enactment. Any renegotiation, extension, revision or modification of any of the terms of a loan after March 1, 1984, is treated under the bill as the issuance of a new loan.

Revenue Effect

The provisions of this section are estimated to increase fiscal year budget receipts by $108 million in 1984, $126 million in 1985, $143 million in 1986, $150 million in 1987, $158 million in 1988, and $166 million in 1989.

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[14] Below-market loans that are made in connection with transactions to which sections 483 or 1274 apply are to be governed by those sections.

3. LIFO Conformity (sec. 163 of the bill and sec. 472 of the Code)

Present Law

Generally, a taxpayers may use the method of accounting for computing taxable income on the basis of which he regularly computes his income in keeping his books provided that such method clearly reflects income. However, if the production, purchase, or sale of merchandise is an income-producing factor, the taxpayer generally must take into account inventories at the beginning and end of each taxable year. Acceptable methods of accounting for inventories include specific identification, average cost, first-in first-out ("FIFO"), and last-in first-out ("LIFO"). However, under the so-called "LIFO conformity" rule, the LIFO method of inventory accounting may not be used for tax purposes unless it is also used in reporting to shareholders, partners, other proprietors, beneficiaries, or for credit purposes.

The Internal Revenue Service has issued several rulings which provide limited exceptions to the LIFO conformity rule in a variety of factual situations. For example, some foreign parent companies with U.S. subsidiaries operate in countries which do not recognize the LIFO method as a proper method of accounting for financial reporting purposes. In Rev. Rul. 78-246, 78-1 C.B. 146, the Service ruled that foreign parent corporations are permitted to convert the operating results of their subsidiaries using the LIFO method to a nonLIFO basis in consolidated financial statements under certain conditions.

In *Insilco Corp.* v. *Commissioner*, 73 T.C. 589 (1980), *aff'd. in an unreported decision* (2nd Cir. 1980), the Tax Court held that the LIFO conformity rules were met by a subsidiary using the LIFO method for Federal income tax purposes where the subsidiary used the LIFO method to compute its income in its financial reports issued to its parent company, even though the parent company converted the subsidiary's earnings to a nonLIFO basis in the parent's consolidated financial statements.

Reasons for change

The LIFO conformity rule is intended to ensure that taxpayers only use the LIFO method for tax purposes when it conforms as nearly as possible to the best accounting practice in the taxpayer's trade or business. Taxpayers may prefer to use the LIFO method, which tends to minimize income in an inflationary environment, for tax purposes, and the FIFO method, which tends to maximize income in such an environment, for financial accounting purposes. The Committee is concerned that taxpayers can avoid the effect of LIFO conformity rule under the *Insilco* decision through the creation of holding companies or subsidiaries. In addition, the Committee is concerned that if a significant number of taxpayers take advantage of the *Insilco* decision, the revenue effect would be substantial. Accordingly, the Committee believes that the LIFO conformity rule should be applied to all financial reports of all corporations in which the taxpayer's inventory is included. However, the Committee believes that limited exceptions to the conformity requirement provided under present law (or the similar limited exceptions provided by the Treasury, if appropriate, in the future) should be allowed.

Explanation of Provision

The bill treats all members of the same group of financially related corporations as a single taxpayer for purposes of the LIFO conformity requirement. The term "group of financially related corporations" means (1) any affiliated group as defined in section 1504 (without regard to the exceptions in sec. 1504(b)) by substituting a 50 percent stock ownership test for an 80 percent stock ownership test and (2) any other group of corporations which issue consolidated financial statements or reports generally to shareholders and others. Thus, the conformity requirement generally applies to a parent corporation which issues financial statements to its shareholders on a consolidated basis with a subsidiary that uses the LIFO method of accounting for tax purposes or which include the results of operations under the equity method of financial accounting of a corporation which is a financially related corporation as defined in the bill.

Under the bill, taxpayers who had relied on *Insilco* will be required either to conform their financial statements to use LIFO for all inventories or would not be allowed to use the LIFO method of accounting for tax purposes.[15] The bill will not affect the authority under present law of Treasury to provide limited exceptions to the conformity rules in specific circumstances.

Effective Date

The provisions of the bill will apply to taxable years beginning after the date of enactment.

Revenue Effect

This provision will increase fiscal year budget receipts by $105 million in 1985, $185 million in 1986 and $200 million in 1987.

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[15] Where a taxpayer had adopted the LIFO method in reliance upon the *Insilco* decision, the Committee expects that some taxpayers may wish to adopt a nonLIFO method as a result of the Committee's bill. In such a case, the Committee intends that such a change would be treated in the same manner as any taxpayer requesting a change from the LIFO method of accounting under present law (i.e., prior permission from the Internal Revenue Service must be obtained before there can be a change in accounting method and any adjustments required by the change in method of accounting would also be treated as under present law). However, the Committee contemplates that the Treasury could provide rules allowing an automatic permission to change to a nonLIFO method for an appropriate transition period.

4. Collapsible Corporations (sec. 164 of the bill and sec. 341 of the Code)

Present Law

A collapsible corporation is one formed or availed of principally for the manufacture, construction, production, or purchase of certain types of property, with the view to the sale or exchange by the shareholders of their stock (or of the liquidation of the corporation) before the realization by the corporation of a "substantial" part of the taxable income to be derived from such property. In general, if stock in a collapsible corporation is sold, exchanged, or the corporation is liquidated in whole or in part (i.e., collapsed), or in the case of certain distributions, any gain recognized by a shareholder which would otherwise be long-term capital gain is considered ordinary income.

In the case of *Commissioner* v. *Kelley*, 293 F.2d 904 (5th Cir. 1961), affirming, 32 TC 135 (1959), *nonacq.*, 1962-1 C.B. 5, withdrawn and acq. substituted, Rev. Rul. 72-48, 1972-1 C.B. 102, the Fifth Circuit held that a corporation will be treated as having realized a "substantial" part of the taxable income to be derived from the property (thereby avoiding collapsible corporation status with respect to that property) if the corporation realizes as little as one-third of the taxable income to be derived from the property. In *Commissioner* v. *Kelley*, the court reasoned that the substantial part requirement related to the part of the taxable income realized and that a substantial part of such income could be realized even though an even greater part of the taxable income to be derived from the property was not realized. This view of the substantial part requirement must be compared with that announced in *Abbott* v. *Commissioner*, 258 F.2d 537 (3rd Cir. 1958), in which the Third Circuit held that the realized part could not be substantial unless only an insubstantial part of the taxable income to be derived from the property remained unrealized.

The statute provides an exception to collapsible corporation treatment under the "70/30" rule (sec. 341(d)(2)). Under this rule, a shareholder who recognizes gain with respect to his stock in a collapsible corporation must determine the amount of the recognized gain attributable to collapsible assets in the corporation. If this amount is 70 percent or less of his total gain for the taxable year, then none of the recognized gain is treated as ordinary income under the collapsible corporation provisions of the Code.

Reasons for Change

The committee believes that property which is collapsible should continue to be so treated until less than a substantial portion of the taxable income to be realized from the property remains unrealized. Thus, in general, the committee has adopted the *Abbott* v. *Commissioner, supra*, view of the "substantial part" requirement.

With respect to the 70/30 rule, the committee is concerned with the possibilities for avoiding collapsible treatment with respect to gain on various stock dispositions subject to the 70/30 rule where a collapsible corporation has two or more separate projects. For example, assume that a corporation builds or acquires two similar inventory-type assets or projects with a view towards collapsing the corporation prior to the time it realizes a substantial part of the taxable income to be derived from either asset. Each asset is of equal value at all relevant times. The corporation is owned entirely by one shareholder. The corporation is liquidated. Under present law, if the selling shareholder caused the corporation to realize one-third of the income to be realized on one asset, prior to the date of the liquidation, that asset would be treated as non-collapsible for purposes of the 70/30 rule. Since less than 70 percent of the recognized gain on the stock sale would be attributable to a collapsible asset, the 70/30 rule would apply to except the sale proceeds from the collapsible corporation provisions of the Code, even though only one-sixth of the total potential income from the assets had been realized.

Explanation of Provision

Under the bill, the collapsible corporation definition of present section 341(b)(1)) is amended. It is explicitly stated that property otherwise collapsible will be collapsible unless at least two-thirds of the taxable income to be derived from the property is realized by the corporation. This would replace the "substantial part" standard of present law. The committee intends that no inference should be drawn from this amendment with respect to the meaning of the "substantial part" requirement of present law.

In addition, the Secretary would be authorized to prescribe regulations describing the extent to which all inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of a trade or business (sec. 1221(1) property) that is of a like-kind should be treated as a single asset in applying the 70/30 rule. The committee intends that these regulations will insure that the two-thirds realization requirement cannot be avoided where the corporation's collapsible section 1221(1) properties are less than two-thirds realized in the aggregate but where some like-kind section 1221(1) properties have been two-thirds or more realized. Thus, if the aggregate of the corporation's collapsible section 1221(1) like-kind properties is less than two-thirds realized, all of the corporation's collapsible section 1221(1) like-kind properties, including any collapsible section 1221(1) property that has been two-thirds or more realized, will be treated as collapsible property for purposes of the 70/30 rule. The committee intends that, for purposes of applying this aggregation requirement under the "70/30" rule, all property with respect to which the taxpayer has, or at any time had, a collapsible view will be treated as collapsible property (i.e., property described in section 341(b)(1), even if it is two-thirds or more realized. Section 1221(1) property which is not collapsible property, and which never was collapsible property, need not be aggregated under this rule.

Effective Date

These amendments are effective for sales, exchanges, and distributions made after December 31, 1983.

Revenue Effect

This provision will increase fiscal year budget receipts by $5 million in 1984, $57 million in 1985, $196 million in 1986 and $305 million in 1987.

5. Modification of Income Averaging (sec. 165 of the bill and secs. 1301 and 1302 of the Code)

Present Law

Under present law, if an eligible individual has at least $3,000 of averageable income, defined as the excess of current year taxable income over 120 percent of average taxable income in the previous four years, then he may be eligible for income averaging. This procedure serves to determine tax liability attributable to averageable income with reference only to the marginal rates applicable to the first 20 percent of this amount, rather than the higher marginal rates which would apply if 100 percent of averageable income were taxed using the regular rate schedule. In other words, income averaging widens the tax brackets by a factor of five with respect to averageable income.

Under income averaging, the individual first calculates what tax liability would be on 120 percent of average taxable income in the previous four years ("average base period income"). Then the individual computes the increase in tax liability which would result if 20 percent of averageable income were added to 120 percent of average base period income. This increase is then multiplied by five and added to the tax liability calculated on 120 percent of base period income in order to determine the individual's tax liability for the year. (These tax liability computations are performed using the current year's rate schedules.)

Reasons for Change

Although income averaging was originally intended to benefit taxpayers with either widely fluctuating income or a sharp jump in real income, many taxpayers whose income has increased merely at the rate of inflation have been eligible for income averaging in recent years.

As a result, the percentage of taxpayers using income averaging has increased substantially in recent years. In 1970, only 1.35 percent of tax returns used income averaging. By 1981, this percentage had increased to 6.87 percent This problem is magnified by indexing because indexing by itself will keep marginal tax rates constant for an individual whose increases in income are entirely attributable to inflation. Thus taxpayers may receive a double benefit from indexing and income averaging. The committee believes that such a double benefit is inappropriate. Furthermore, the 23-percent across-the-board reduction in marginal tax rates enacted in 1981, including a top rate of 50 percent on ordinary income and 20 percent on long-term capital gains, greatly reduces the need for an income averaging provision as generous as that provided by present law.

Explanation of Provision

The bill provides that averageable income is defined as the amount by which the taxable income for the current year exceeds 140 percent, instead of 120 percent as under present law, of the average base period income. In addition, the base period is shortened to be the three prior years. Finally, the income averaging formula is modified so that it widens the tax brackets by a factor of four with respect to averageable income. As a result of these changes, only those taxpayers with an unusual increase in income will receive a benefit from using income averaging, rather than taxpayers with more normal increases in income who benefit under present law.

Effective Date

This provision will apply to taxable years beginning after December 31, 1983.

Revenue Effect

This provision will increase fiscal year budget receipts by $133 million in 1984, $1,994 million in 1985, $1,886 million in 1986, $2,053 million in 1987, $2,226 million in 1988, and $2,404 million in 1989.

6. Limitations on Depreciation and Investment Tax Credit for Luxury Automobiles (sec. 166 of the bill and secs. 162 and 168 of the Code)

Present Law

A taxpayer who acquires an automobile for use in a trade or business and uses it for business purposes is entitled to an investment tax credit and cost recovery deductions under the Accelerated Cost Recovery System (ACRS), in addition to deductions for operating and maintenance expenses.

The amount of the regular investment credit for automobiles is 6 percent of cost. Basis adjustment is required in this case, so that ACRS deductions are allowed for 97 percent of cost. Alternatively, the taxpayer may elect a reduced investment credit equal to 4 percent of cost, in which case ACRS deductions are allowed for 100 percent of cost. In either case, 25 percent of the amount that may be written off is deductible in the first year, 38 percent is deductible in the second year, and the remaining 37 percent is deductible in the third year, unless the taxpayer elects an optional recovery life and method under ACRS.

In general, no gain or loss is recognized on equipment, including automobiles, which the taxpayer trades in as partial payment for new equipment of a like kind. For purposes of determining cost recovery deductions, the basis of the new equipment is the adjusted basis of the trade-in plus whatever additional cash is needed to acquire the new equipment (Code sec. 1031).

Reasons for Change

The committee believes that the investment incentives afforded by the investment credit and ACRS should be directed to capital formation, rather than to subsidize the element of personal consumption associated with the use of very expensive automobiles. Luxury cars and other cars provide the same services necessary for the conduct of a business, and tax benefits should be available to that extent. Beyond that point, however, the extra expense of a luxury automobile operates as a tax-free personal emolument which the committee believes should not qualify for tax credits and deductions.

In addition, the committee understands that significant compliance problems exist under current law due to overstatements of the proportion of business use of automobiles. The committee believes that an additional measure should be provided to assist compliance and enforcement in this area.

Explanation of Provisions

The bill limits the investment tax credit and cost recovery deductions to the first $21,000 of the cost of an automobile used entirely for business purposes. Accordingly, if a taxpayer purchases for $45,000 a car the entire use of which otherwise qualifies for business deductions, no investment credit or cost recovery deductions will be allowed for $24,000 of the cost. In the event more than one person holds an interest in an automobile, the aggregate basis taken into account by all persons holding the interests will not exceed $21,000 for investment credit and cost recovery purposes. The $21,000 limitation is adjusted annually, beginning in 1985, to take account of inflation as measured by the automobile component of the Consumer Price Index for all urban consumers. The portion of cost allowed under these rules is, as under present law, prorated for the proportion of business use. Thus, for an automobile which costs more than $21,000, the investment credit and cost recovery deductions apply only to $16,800 of cost of an automobile 80 percent of the use of which is for business purposes.

The bill applies generally to automobiles which are rated at 6,000 pounds gross vehicle weight or less. However, the bill does not apply to ambulances, hearses, and automobiles used directly in the trade or business of transporting persons or property. Also, it does not apply to vehicles other than automobiles, such as vans or trucks.

The limitation does not apply to an automobile leased or held for leasing by a person who is regularly engaged in the business of leasing automobiles. However, if the automobile is leased under a long-term lease, only the allowable portion of the lessee rental payments will be deductible. For this purpose, the allowable portion means the fraction the numerator of which is the limitation in effect for the calendar year in which the automobile is placed in service under the lease, and the denominator of which is the fair market value of the automobile when placed in service. Also for this purpose, a lease the term of which is 30 days or more (including options to renew or extend) is a long-term lease.

The bill provides a rule to coordinate the operation of the limitation with the rules for determining basis in the case of a like-kind exchange.

In addition, the bill provides that, unless the taxpayer establishes to the contrary, at least 50 percent of the use of an automobile during a taxable year will be treated as personal use (i.e., use which is not in a trade or business or for the production of income). This presumption applies to any automobile, whether or not the $21,000 limitation for investment credit and cost recovery purposes applies to the automobile. This provision does not affect the present law rule that the taxpayer must fully substantiate any proportion of business use that is claimed. The committee intends, however, to elevate the standard of proof in cases where the proportion of business use claimed exceeds 50 percent, and clearly does not intend that a taxpayer may claim a deduction for 50 percent of the use of an automobile without full substantiation.

Effective Date

The provisions relating to the $21,000 limitation are effective for automobiles placed in service after March 1, 1984, in taxable years ending after that date. The provision relating to the presumption concerning the proportion of personal use is effective for taxable years beginning after 1984.

Revenue Effect

These provisions are estimated to increase fiscal year budget receipts by $20 million in 1984, $79 million in 1985, $130 million in 1986, $160 million in 1987, $180 million in 1988, and $194 million in 1989.

7. Transfers of Depreciable Property Between Related Parties (sec. 167 of the bill and sec. 1239 of the Code)

Present Law

In order to prevent tax-motivated transactions, transfers between related parties often receive special treatment under the Internal Revenue Code. One provision provides that a transferor will be treated as receiving ordinary income rather than capital gain on the transfer of property to a related party when that property is depreciable property in the hands of the transferee (sec. 1239). For this purpose, related parties include a person and all corporations or partnerships controlled by that person.

The courts have held that the transfer of a patent application as opposed to a patent does not fall within this anti-abuse rule because the application itself is not depreciable property (*Lan Jen Chu* v. *Commissioner*, 486 F. 2d 696 (1st Cir., 1973)). However, once the application is granted, the transferee can depreciate the resulting patent.

Reasons for Change

The committee believes that the scope of section 1239 should be broadened in order to prevent taxpayers from effectively selling certain property to themselves at capital gains rates and receiving cost recovery benefits on a stepped-up basis.

Explanation of Provision

The provision of the Code relating to gains from the sale of depreciable property between related parties (sec. 1239) is amended to treat a patent application as depreciable property, thus requiring that any gain recognized to the transferor be treated as ordinary income rather than capital gain.

Also the definition of related persons is expanded to include a taxpayer and trust in which the taxpayer has a beneficial interest (other than a remote contingent interest).

Effective Date

The provision will apply to transfers after March 1, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $5 million annually.

TITLE II—LIFE INSURANCE TAX PROVISIONS

A. Present Law

1. Pre-1959 Taxation of Life Insurance Companies

Before 1921, insurance companies were taxed in substantially the same manner as other corporate entities. Under the Revenue Act of 1921 and subsequent legislation, however, life insurance companies were accorded special tax treatment.

From 1921 through 1957, a life insurance company was only taxed on investment income. Premiums were excluded from the income computation, as were losses and expenses incurred in underwriting operations, and gains and losses from the sale of investment assets. In addition, various formulas were established to exclude from taxation the portion of investment income necessary to satisfy the company's obligations to policyholders under its insurance contracts. Although the formulas varied from time to time, their purpose was always to compute that portion of investment income allocable to policyholders. This approach of taxing income only to the extent not needed to fund current and projected liabilities to policyholders as determined under State law has been referred to as taxing a company on its free investment income.

2. The 1959 Act

In general

The general framework under which life insurance companies are taxed under present law was adopted in the Life Insurance Company Income Tax Act of 1959 (secs. 801-820 of the Code).[1] The 1959 Act significantly changed prior law by attempting to measure the total income of a life insurance company rather than just its free investment income. Nonetheless, as described below, under the 1959 Act various deductions and "special rules" resulted in an income tax base which fell short of total income.

Computing taxable income

Under the 1959 Act, a life insurance company is taxed on the lesser of its taxable investment income or its gain from operations. If a company's gain from operations exceeds its taxable investment income, the company is taxed on 50 percent of such excess. The tax with respect to the other half of the excess of gain from operations over taxable investment income is deferred; that half (along with amounts deducted for nonparticipating contracts, accident and health and group life insurance contracts) is added to a deferred tax account (policyholders' surplus account) and, subject to certain limitations, is taxed only when distributed to shareholders of a stock company.[2] Thus, under the 1959 Act, a life insurance company must compute its gain (or loss) from operations and its taxable investment income. The computation of gain from operations begins with the company's total income including the company's share of investment yield,[3] net capital gain, premiums and other considerations, decreases in insurance reserves, and all other amounts. From this total, a life insurance company is allowed deductions. These generally include the usual deductions available to taxpayers for business or investment expenses, an operations loss deduction, and certain deductions unique to the insurance business such as for payments of claims and death benefits, for increases in reserves (to the extent not funded out of the policyholders' share of investment income), and for certain payments under assumption reinsurance. All life insurance companies are also permitted to claim a small business deduction. Finally, there are three special deductions for policyholder dividends, nonparticipating contracts, and group life insurance and accident and health insurance contracts, which are subject to limitations. Unlike the deduction for policyholder dividends, the other two special deductions do not reflect actual cash expenditures by the company or even the commitment of funds to a reserve required under State law.

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[1] Public Law 86-69, June 25, 1959. The Act was generally effective for taxable years beginning after December 31, 1957.

In addition, a deduction is allowed for the company's allocable share of tax-exempt income and the amount of any dividends received by the company that are deductible under provisions generally applicable to all corporations. The initial inclusion of tax-exempt income followed by the later deduction of the company's share has the effect of allocating a portion of tax-exempt income to the policyholders' share which is not includible in the company's taxable income in any event. Thus, tax-exempt income is not as attractive to life insurance companies as to other taxpayers as a means of reducing their effective tax rate.

To compute taxable investment income, it is necessary to calculate investment yield. Investment yield is the excess of gross investment income over all applicable investment expenses. Then, the policyholders' share of investment yield is excluded.[4] Finally, the company may deduct from its share of investment yield its share of tax-exempt investment income and of the deduction for dividends received.

Under the 1959 Act and present law, the computation of a life insurance company's taxable investment income is important for two purposes. First, as discussed above, a company may be taxed on its taxable investment income. Second, for purposes of computing gain from operations, the aggregate amount allowed for the special deductions is limited by reference to the amount of the company's taxable investment income. Prior to amendment in the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) (TEFRA), the 1959 Act provided that the amount of deductions allowed for policyholder dividends, for nonparticipating contracts, and for accident and health and group life insurance contracts be limited to the amount by which gain from operations (before those deductions) exceeded taxable investment income, plus $250,000. This limitation was designed to ensure that most large companies be subject to tax at least on their free investment income (reduced by no more than $250,000). As explained below, this $250,000 statutory amount was modified in TEFRA.

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[2] Typically, this will be incurred only if a company is acquired and liquidated to achieve an increase in the basis of its assets.

[3] The computation actually begins with gross investment income, less investment expenses, from which the interest contractually required to be set aside for policyholders is excluded. A portion of an item required to be set aside for policyholders is referred to as the policyholders' share of such item. The excess of the amount of the item over the policyholders' share is the company's share.

[4] Under the taxable investment income computation, the policyholders' share of investment yield is determined in part by use of the "Menge formula," which arithmetically adjusts State required life insurance reserves to allow the crediting of earnings at an adjusted rate that takes into account the actual earnings rate of the individual companies. In general, the effect of this computation is to allocate to the policyholder an amount at least equal to the reserves required under State law (unless under the permanent provisions, the current earnings of the company exceed 10 percent). The 1959 Act does not establish a Federal standard for computation of reserves or require that they be based on a company's actual experience.

Tax phases

The provisions described above for computing a life insurance company's taxable income require a comparison of the company's taxable investment income and its gain from operations. Depending on the mix of these elements, two companies with the same aggregate pre-tax income may owe different amounts of tax. The result is that most life insurance companies can be classified on the basis of the mix of investment income and underwriting gain as being in one of three tax categories.

Phase I Company

Under the 1959 Act, a Phase I company has a gain from operations that is less than its taxable investment income, and has reached the limit on the special deductions. A life insurance company that would typically be in this phase is an established mutual company, which might have substantial underwriting income before any policyholder dividend distributions. This company could use the deduction for policyholder dividends to reduce gain from operations.

Phase II (Positive) Company

A Phase II (Positive) company has a gain from operations in excess of its taxable investment income, taking into account any policyholder dividends. A typical life insurance company taxed under this phase is an established stock company that has no State law requirement to share favorable investment and underwriting experience with its policyholders through policyholder dividends. A Phase II (Positive) company's taxable income is generally the sum of its taxable investment income, and one-half of the excess of its gain from operations over taxable investment income. Because a company's gain from operations is roughly the sum of its taxable investment income and its underwriting gain, a Phase II (Positive) company is taxed currently on one-half of its underwriting gain while the other half becomes part of the policyholders' surplus account (known generally as the Phase III account).

Phase II (Negative) Company

A Phase II (Negative) company has a gain from operations that is less than its taxable investment income by more than $250,000 (under the 1959 Act) because of underwriting losses. Typically, a Phase II (Negative) company is a new or growing stock life insurance company that has underwriting losses because of high start-up costs associated with new insurance business. In such a case, taxable investment income is reduced by the expenses of operating the company because the underwriting income alone is not sufficient to cover the costs of the insurance business. A Phase II (Negative) company's taxable income is its entire gain from operations.[5]

3. TEFRA Changes

In TEFRA, Congress addressed certain tax avoidance techniques available to life insurance companies through both permanent provisions and temporary provisions (effective, generally, for 1982 and 1983). The latter allowed a more thorough Congressional review of the tax laws applicable to life insurance companies and their products.

Modco and reinsurance

Provisions governing modified coinsurance transactions were permanently repealed. In addition, provisions were adopted to prevent abuse through dividend reimbursement agreements between insurance companies engaged in reinsurance transactions. Further, provisions were added to deny deductions for interest paid on indebtedness used in reinsurance transactions, and to grant Treasury special income allocation and recharacterization authority with respect to reinsurance transactions between related parties. TEFRA provided, in addition, that for years before 1982 (except in the case of fraud) the determination of whether a reinsurance contract satisfied the modified coinsurance requirements of then existing law would be made solely by reference to the terms of the contract.

Special deductions

TEFRA provided a temporary change in the limitation on the special deductions for policyholder dividends, nonparticipating contracts, accident and health and group life insurance contracts. This provision generally raised the $250,000 statutory dollar amount under the 1959 Act to $1 million, but targeted it to small life insurance companies.

TEFRA also provided an alternative limitation on the special deductions. Under this provision, the maximum amount that could be deducted was the sum of (1) 100 percent of policyholder dividends on pension contracts, (2) the statutory amount , and (3) 85 percent (77-1/2 percent for mutual companies) of the tentative deduction for policyholder dividends, other than policyholder dividends on pension business. For most companies, this alternative was substantially more generous than the limitation provided under the 1959 Act.

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[5] In addition to the three tax categories discussed above, there is also a "Phase I Corridor" company, which is taxed on its entire gain from operations that is less than taxable investment income by an amount less than $250,000 (under the 1959 Act), and a "Phase III" company, which has taxable income that includes shareholder distributions of, or subtractions from, previously tax-deferred amounts from the policyholders' surplus account.

Computation of reserves

TEFRA contained a number of temporary provisions relating to the computation of reserves. First, interest guaranteed in a contract in excess of the interest that would be earned at the rate assumed for purposes of computing statutory reserves could not be taken into account in computing the reserves to the extent such excess interest is guaranteed beyond the taxable year. Second, under TEFRA, the amount of investment yield that could be allocated to group pension contracts was limited to the amount actually credited to such contracts. Both of these provisions had the practical effect of reducing the exclusion for the policyholders' share of investment yield. Third, under TEFRA, the status of a life insurance company could not be changed because of its reserve treatment of group pension funds. This prevented reclassification for tax purposes of life insurance companies as casualty insurance companies—which would be adverse to certain stock companies and favorable for certain mutual companies—because they have removed life contingencies from pension contracts. Fourth, an arithmetic adjustment to reserves contained in the 1959 Act (the Menge formula) was changed to a geometric adjustment, allowing a slightly more generous policyholders' share of investment yield. In addition to these temporary changes, there was a permanent reduction in the amount allowed a life insurance company under the approximate formula for revaluing preliminary term reserves for insurance other than term life insurance. Under TEFRA, reserves are increased by $19 per $1,000 of insurance in force and reduced by 1.9 percent of the reserves (rather than by $21 per $1,000 reduced by 2.1 percent, as under prior law).

Consolidated returns

Under a temporary provision, related life insurance companies were allowed to compute their respective taxable incomes before consolidation (a bottom-line method). This method was allowed instead of requiring consolidation of income items before computing consolidated taxable income (a phase-by-phase method).

Annuities

TEFRA also contained permanent changes for the tax treatment of annuity contracts to companies and to policyholders. In general, companies are allowed the full deduction for amounts credited to annuity contracts. For a policyholder, cash distributions from an annuity contract before the annuity starting date are taxable to the policyholder to the extent there is income in the contract. Also, if a portion of such an income distribution is attributed to an investment in the contract that was made within 10 years of the distribution, there is a 5-percent penalty tax on such portion. There are, however, a number of exceptions to this rule; for example, no penalty applies to income distributions on or after the policyholder reaches age 59-1/2.

Flexible premium life insurance

Finally, TEFRA adopted temporary guidelines with respect to flexible premium life insurance contracts (i.e., universal life and adjustable life), which must be met in order for the death proceeds from such contracts to be considered life insurance for tax purposes.

B. Reasons for Change

Overview

The changes in the tax treatment of life insurance companies, life insurance and annuity products, and policyholders in the bill are the result of a lengthy study by the committee and one of its subcommittees. During the course of the study it became apparent that, as a result of two factors, changes are required. The first factor is the unusually large increase in interest rates that has occurred since 1959. The second is the Congress' desire to simplify the Code and eliminate the extraordinarily complex three-phase tax structure of present law.

Rising interest rates have caused several changes in the tax position of the life insurance companies since the enactment of the 1959 Act. First, with investment income increasing because of rising interest rates, the tax liability of mutual (and, to a lesser extent, stock) insurance companies began to increase. Second, these companies made extensive efforts to reduce their increasing Federal income tax liability by entering into larger volumes of modified coinsurance transactions by which investment income was recharacterized as underwriting income. In 1981, one of the largest mutual companies used modified coinsurance so extensively that it reduced its tax to zero. Third, some stock companies, in order to compete with other financial intermediaries, began to offer investment-oriented products that, in effect, allowed them to distribute currently high investment yields tax-free to policyholders. Mutual companies were slower to enter this market because their ability to pay policyholder dividends already permitted them to pass through to policyholders favorable investment experience, although some of those dividends were taxed at the company level because of the limitation on the deduction for policyholder dividends.

In 1982, the Congress responded to these changes in the life insurance industry through a number of tax changes including a permanent repeal of the provisions for the special tax treatment of modified coinsurance. At that time it was estimated that the repeal of modco would increase revenues by $2.3 billion in 1982 over an estimated prior law tax burden of $1.7 billion. Concern over the effect of so substantial a change in tax burdens led to enactment of a series of temporary provisions which generally had the effect of reducing the industry tax burden by an estimated $1.2 billion for 1982 and by the same amount for 1983. These provisions expired at the end of 1983.

Inadequacies of the 1959 Act

In reviewing the 1959 Act, the committee identified numerous inadequacies. First, drafted in the middle of a period of low and stable interest rates, the 1959 Act distinguishes between investment and underwriting income and taxes them differently. While interest rates remained stable, the 1959 Act functioned reasonably well, although it never taxed companies on their full economic income. With increases in interest rates and the evolution of new insurance products, however, the 1959 Act resulted in an inappropriate measure of life insurance company income. As a result, the committee concluded that a proper measure of the income of life insurance companies can be obtained only by replacing the complex, three-phase structure of present law with a simpler, single-phase tax.

A second inadequacy of the 1959 Act which the committee identified is that the Act includes a variety of deductions and deferral items that do not relate to a proper measure of a life insurance company's income and which provide extraordinary benefits for some companies and no benefits for other companies. In particular, the special deductions for accident and health insurance and for nonparticipating policies bear no relationship to actual expenditures by companies and tend to benefit mature stock companies more than other companies. Similarly, the deferral of tax on underwriting income is, in effect, beneficial only to certain stock life insurance companies. The revaluation of reserves from amounts computed under a preliminary term method to amounts computed under a net level premium method allows a deduction for amounts that are not, in fact, added to reserves and tends to benefit primarily expanding, newer, stock life insurance companies. Finally, the rules relating to deduction of policyholder dividends, which primarily affect mutual companies, operate to assure that companies are taxed on at least their investment income. These rules do not attempt to distinguish between amounts returned to policyholders as customers and amounts distributed to them as owners of the mutual company. As a result, a mutual company may be taxed on a base that is either greater than or less than its economic income.

A third concern with respect to the 1959 Act relates to the tax treatment of reserves maintained by life insurance companies. Under present law, a company's reserves are based on its statutory reserves, which are computed using assumptions under State law. The result is a significant overstatement of liabilities in comparison to those measured under realistic economic assumptions. The committee concluded that a more accurate measure of liabilities for tax purposes can be achieved by imposing specific rules for the computation of tax reserves that result in a reserve which approximates the least conservative (smallest) reserve that would be required under the prevailing law of the States.

A fourth concern which the committee identified is a significant shifting of tax toward the mutual company segment of the industry. As interest rates rose, investment income became an increasingly large portion of life insurance company income. Many stock companies can offset at least a portion of this income with losses generated by their underwriting activities. Mutual companies, on the other hand, generally charge higher premiums for their products and are less likely to have underwriting losses. Thus, with the permanent repeal of the provisions governing modified coinsurance transactions, there may be a significant shifting of tax under the 1959 Act toward mutual companies.

New approach

The single-phase tax contained in the bill was designed by reference to a stock life insurance company model. This choice was made because it provides a relatively simple tax structure for life insurance companies that bears a close resemblance to the general structure of corporate income taxation. Further, the choice of the stock company model reflected the view that life insurance is primarily a commercial activity, and that no company should engage in it without being subject to Federal corporate income taxes.

In redesigning the statutory scheme for taxation of life insurance companies, the committee was concerned that the new provisions not unduly prejudice companies by suddenly increasing their tax liability by substantial amounts. Although the committee was concerned that deductions which do not reflect economic expenses generally are inappropriate, it nonetheless concluded that the difficulties which might result from a sudden increase in the industry's tax burden warranted an exception in this case. Thus, the committee provided special rules for smaller life insurance companies since most of these companies enjoyed substantial benefits under existing law. In addition, the committee bill provides an across-the-board rate reduction for life insurance companies which will cushion the impact of the new rules and assure their tax-related competitive position relative to other financial intermediaries, and other tax-exempt entities in direct commercial competition with life insurance companies.

Life insurance products

Life insurance policyholders traditionally have benefited from a special position under the Code. Under present law, policyholders benefit principally from the tax-free accumulation of cash value under life insurance policies and the deductibility of interest payments for indebtedness. Cash values accumulate under any one of several premium payment systems for whole life insurance which result in larger premium payments in the early years of a contract than required to fund current insurance protection. The buildup occurs when a level premium payment plan applies to the policy, and the premium payments in the early policy years exceed the current cost of insurance computed using assumed mortality table and interest rates. In the later years of the contract, the annual cost of insurance is higher and for the nominal face amount of coverage may exceed the annual level premium payment. The cash value buildup in the policy, however, reduces the actual insurance risk and, therefore, the cost of insurance. Under present law, the policyholder is not taxed on increases in the cash value (for example, from investment earnings) unless the contract is surrendered prior to the death of the insured for an amount in excess of the gross premiums paid. Both cash value and reserves grow as the balances earn interest, but the accruals of interest are not included in the policyholder's gross income and therefore are not subject to taxation. In addition, the growing cash value may be used as collateral for a loan from the insurance company. The policyholder may deduct the interest payments made with respect to this loan just as all interest payments on loans are deductible. In this case, however, significant portions of the principal amount (i.e., cash value) that is borrowed has accrued as untaxed interest income. Thus, an insurance policyholder may withdraw his cash value through the loan mechanism without recognizing gain and deduct his cost of avoiding the recognition of income. This combination of deferral, access to the income, and interest deductions is unique to life insurance. With respect to other forms of tax-free income, such as income from all-savers certificates (the last of which have recently matured) and bonds issued by State and local governments, borrowing on the collateral of the bond or certificates is not permissible. With respect to an individual retirement account (IRA), the deposits and interest accruals occur tax-free, but they are taxed when drawn upon in later years within statutory limits; premature withdrawals, including loans, are subject to a penalty tax and also are included in the taxpayer's gross income in the withdrawal year.

In light of the significant tax advantages associated with life insurance products, the committee undertook a review of those products and their treatment. Four areas of concern were identified as appropriate for legislation. First, in recent years, companies have begun emphasizing investment-oriented products that maximize the advantages of the deferral provided in the Code. When compared to traditional products, these products offer greater initial investments or higher investment returns, or both. In response, the committee adopted a definition of life insurance that treats as currently taxable investments, those life insurance policies that provide for much larger investments or buildups of cash value than traditional products.

A second area of concern was the treatment of annuity contracts. The committee believes that the present-law treatment of annuities (deferral of tax on investment income) is justified only by the retirement savings purpose of annuities. Thus, an exception to the early withdrawal penalty for amounts earned on investments that are kept in the annuity contract for at least 10 years was viewed as inappropriate, since it permits penalty-free pre-retirement withdrawals. Similarly, the committee believes deferred income in an annuity should be taxed to the annuity owner during his or her lifetime. Thus, if the owner dies before annuitization, the deferred income should be included in the owner's last income tax return.

A third concern identified by the committee was the use of policyholder loans to withdraw cash values from life insurance contracts without tax on the inside buildup. To limit possible abuses of this loan feature, the committee decided to impose a high limit on the deductibility of interest on these types of loans.

Finally, the committee believes that present-law limits on the amount of term life insurance coverage that can be provided to employees without inclusion of the cost of such insurance in the income of the employee should also apply to retired employees.

Nondeductible IRA contributions

The committee recognizes that an individual is permitted to make nondeductible payments to purchase a tax-deferred annuity contract and that the income earned under the contract is not taxed until amounts are paid under the contract. The committee believes that individuals should be encouraged to save for retirement by making nondeductible contributions, within limits, to IRAs. To provide similar tax treatment for nondeductible contributions under tax-deferred annuity contracts and nondeductible contributions to IRAs, the committee intends that amounts paid or distributed out of nondeductible contributions made to an IRA will be taxed first on the income attributable to nondeductible contributions. Finally, the committee recognizes the need for separate accounting and recordkeeping requirements with respect to nondeductible IRA contributions in order to ensure that the nondeductible contributions and the income attributable thereto retain their character when paid or distributed from the IRA or when rolled over to another IRA.

C. Explanation of Provisions

1. Overview of the bill

General rules

Title II of the bill contains four subtitles. Subtitle A is the amendment that provides a complete substitute for the present-law tax treatment of a life insurance company. Part I of Subchapter L of the Internal Revenue Code, sections 801-819A, will be repealed and will be replaced by the amendments in subtitle A of title II of the bill. Subtitle B provides new rules relating to the treatment of life insurance products which are in addition to those of present law. Subtitle C provides for nondeductible contributions to IRAs, and subtitle D provides for certain studies and reports to the tax committees relating to the tax burden on life insurance.

New Code section 801 imposes an income tax on the taxable income of a life insurance company as defined in section 816. Taxable income is defined as life insurance company gross income less life insurance company deductions. Life insurance company gross income is defined in section 803. The deductions which are allowed to be made from gross income are set forth in section 804, and described in some detail in section 805 (the general deductions) and section 806 (the special deductions). Further specification of these deductions is provided in sections 807 and 817 (rules for reserves and variable contracts), sections 808 and 809 (policyholder dividends), and section 810 (operations loss).

Accounting provisions that relate to life insurance company taxation are contained in section 811. In section 812, the company's share and policyholders' share are defined, and the proration of various types of income between the two shares also is described. Sections 813 and 814 relate to foreign life insurance companies and contiguous country branches of domestic life insurance companies.

Subtitle B of title II contains the definition of a life insurance contract (sec. 221), the treatment of annuity contracts (sec. 222), the limitation on the interest deduction in case of life insurance loans (sec. 223), and further rules relating to group-term life insurance purchased for employees (sec. 224).

Further, subtitle C provides for the allowance of nondeductible contributions to IRAs, beginning in 1984, of up to $1,750 per year for each taxpayer having a tax-deferred IRA.

Subtitle D contains requirements for studies which will report upon the various aspects of the industry (e.g., revenues, segment balance, etc.). These Treasury studies are to be completed at various dates and reported to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

Relationship to the 1959 Act

Although the bill amends the Internal Revenue Code by repealing the life insurance company taxation provisions of the 1959 Act and replacing them with an entire new Part I of subchapter L, the committee intends that the provisions of the new Part I which are based on present law be interpreted in a manner consistent with present law. Thus, where provisions of existing law are incorporated in the bill, the committee expects that, in the absence of contrary guidance in this report, the regulations, rulings, and case law under existing law may serve as interpretative guides to the new provisions.

2. Tax Treatment of Life Insurance Companies

a. Definition of a life insurance company (new sec. 816)

Present Law

A company is taxed as a life insurance company if (1) it is an insurance company; (2) it is engaged in the business of issuing life insurance and annuity contracts (either separately or in combination with accident and health insurance), or noncancellable accident and health insurance contracts; and (3) more than 50 percent of its total reserves are life insurance reserves or unearned premiums and unpaid losses (whether or not ascertained) on noncancellable life, accident or health policies not included in life insurance reserves.

Under present law, there is no statutory definition of an insurance company. Treasury regulations, however, provide that an insurance company is a company "whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies." (Treas. Reg. sec. 1.801-3(a)).

Life insurance reserves are amounts which are (1) computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and (2) are set aside to mature or liquidate future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident contracts involving (at the time the reserve is computed) life, health or accident contingencies. Also, life insurance reserves must be required by law. The term total reserves means (1) life insurance reserves, (2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and (3) all other insurance reserves required by law. The term total reserves does not include deficiency reserves.

Explanation of Provision

The bill generally adopts the present-law test for determining whether an insurance company is a life insurance company and, for this purpose, continues to look to properly computed statutory reserves. However, for purposes of qualifying as a life insurance company, the bill adopts a statutory definition of an insurance company. Specifically, for purposes of qualifying as a life insurance company, a company must be one for which more than half of the business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risk underwritten by insurance companies. By requiring more than half rather than that the "primary and predominate business activity" be insurance activity, the bill adopts a stricter and more precise standard for a company to be taxed as a life insurance company than does the general regulatory definition of an insurance company applicable for both life and nonlife insurance companies under present law. Whether more than half of the business activity is related to the issuing of insurance or annuity contracts will depend on the facts and circumstances. Factors to be considered will include the relative distribution of the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities. It is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Code; see, e.g., *Service Life Insurance Co. v. United States*, 189 F. Supp. 288, *aff'd on other grounds*, 293 F. 2d 78 (8th Cir. 1961).

Because the definition of a life insurance company, under the bill, looks to the activities of the company for the entire taxable year, a company will be characterized for that year as a life insurance company or as a property and casualty company on the basis of its activities for the entire year. Thus, if more than half a company's business activity during the taxable year is the issuing of insurance and annuity contracts or the reinsuring of risks underwritten by insurance companies, and if more than 50 percent of its total reserves for the taxable year are life insurance reserves or unearned premiums and unpaid losses on noncancellable life, accident or health policies, then the company would be taxable as a life insurance company for such taxable year.[6] Any definitional change from present law, however, is not intended to override any authority of Treasury to issue regulations under section 1502 relating to the filing of consolidated returns.

The bill adopts the same definition of a life insurance reserve as under present law. In doing so, the special recognition afforded noncancellable accident and health insurance contracts in the 1959 Act as being comparable to life insurance contracts because of their long-term rate commitments is continued.

In general, the bill adopts the present-law definition of total reserves. However, the bill also provides that, for purposes of determining whether an insurance company is a life insurance company, amounts set aside and held at interest to satisfy obligations under contracts which do not contain permanent guarantees with respect to life, accident, or health contingencies shall not be included in life insurance reserves or in total reserves. Thus, these amounts are not included in either the numerator or the denominator of the qualification fraction when determining whether a company's life insurance reserves and unearned premiums and unpaid losses on noncancellable accident and health insurance contracts comprise more than half its total reserves.[7] This provision resolves for future years a question under present law as to how certain pension funds that do not contain permanent annuity purchase rate guarantees should be treated.[8] The Internal Revenue Service has ruled that a reserve for a benefit is not a life insurance reserve unless a life benefit is permanently guaranteed under the contract (Rev. Rul. 77-286, 1977-2 C.B. 228). The provision of the bill substantially adopts this position and extends it to total reserves also, but only for purposes of the qualification fraction. The fact that such funds are not treated as insurance reserves for purposes of the qualification fraction is not intended to have any affect on the characterization of the contracts or of the company issuing the contracts. Rather, whether a contract with less than a permanent guarantee should be considered an insurance or annuity contract would depend on the terms of the contract. That is, it will depend on whether the company has assumed a significant insurance risk or has made an annuity guarantee (for life or a fixed period). Generally, the assumption of solely an investment risk would not give rise to an insurance liability.

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[6] In determining whether a company has the requisite reserve qualifications, the amount of the reserve taken into account for the year is the mean of the reserve at the beginning and the end of the year.

[7] If these contracts have any insurance or annuity purchase rate guarantees (for life or a fixed term), then the premiums will be taken into income and the increase in the fund will be treated as increases in a reserve item under section 807(c)(3) or (4). If there are no guarantees whatsoever, then no income will be taken into account and no reserves will be treated as increased for purposes of the reserve deduction.

b. Computation of life insurance company taxable income (new secs. 801, 803, 804, 805, and 806)

Present Law

A life insurance company currently is subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system a company is taxed currently on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeds its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations is accounted for as part of a policyholders' surplus account and, subject to certain limitations, is taxed only when distributed to stockholders or upon corporate dissolution (Phase III). Thus, although life insurance companies are taxed at the normal corporate rates under present law, special accounting rules are provided for computing taxable income. Consistent with the taxation of other taxpayers, net capital gain that is taxable to the company may be subject to an alternative tax.

Explanation of Provisions

Life insurance company taxable income (new sec. 801)

Under the bill, a life insurance company will be taxed at corporate rates, under a single-phase system, on its life insurance company taxable income (LICTI). LICTI is life insurance gross income reduced by life insurance deductions. As under present law, net capital gain that is taxable to the company may be subject to an alternative tax. A stock life insurance company will be taxed, at corporate rates, on any distributions from a pre-1984 policyholders' surplus account.

In general, as described below, a special life insurance company deduction and a small life insurance company deduction each result, in effect, in a lowering of the tax rates on LICTI. However, if amounts are subject to the alternative tax on capital gains, the special life insurance company and small life insurance company deductions do not reduce the amounts subject to that tax, because it already provides a lower than normal tax rate (new sec. 801).

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[8] The question was temporarily mooted by a TEFRA provision which prevented any company from changing its life insurance company status because of the treatment of such reserve funds.

Life insurance gross income (new sec. 803)

Under the bill, life insurance gross income is the sum of (1) premiums, (2) decreases in certain reserves, and (3) other amounts generally includible by a taxpayer in gross income. For these purposes, premiums consist of the gross amount of premiums and other consideration received on insurance and annuity contracts reduced by return premiums paid to policyholders, such as on the cancellation of a policy, and premiums and other consideration paid to another insurer on indemnity reinsurance (new sec. 803).

As under present law, the premiums and other consideration taken into account include advance premiums, deposits, fees, assessments, consideration in respect of assuming liabilities under contracts not issued by the taxpayer, and any policyholder dividends reimbursable by a reinsurer. Return premiums do not include amounts paid to policyholders, which are not fixed in the contract but depend on the experience of the company or the discretion of the management, except in the case of return premiums or other consideration returned to another life insurance company under an indemnity reinsurance contract. Furthermore, amounts rebated or returned due to policy cancellations or to erroneously computed premiums are to be treated as return premiums.

The use of the term "indemnity reinsurance" in the bill, instead of "reinsurance ceded" under present law, is not intended to be a substantive change from present law. Likewise, the reference to "insurance and annuity contract" rather than to "insurance and annuity contracts (including contracts supplementary thereto)" is not a substantive change from present law. A general provision, applicable to the life insurance company part of the Code only, states that any reference to insurance and annuity contracts includes any contract supplementary thereto (new sec. 818(d)).

Life insurance deductions (new sec. 804)

Under the bill, life insurance deductions consist of "general" life insurance deductions (new sec. 805), the "special life insurance company deduction" (new sec. 806(a)), and the "small life insurance company deduction" (new sec. 806(b)).

The general deductions (new sec. 805)

The general deductions are generally the same as the deductions allowed under present law, except that the deductions currently available to life insurance companies for nonparticipating and group life contracts and accident and health contracts are eliminated. The general deductions, under the bill, are the deductions for (1) claims and benefits accrued, and losses incurred (whether or not ascertained) during the taxable year on insurance and annuity contracts, (2) net increases in reserves (see item d. below), (3) policyholder dividends (see item e. below), (4) a modified dividends-received deduction, (5) operations losses (see item f. below), (6) consideration paid for assumption reinsurance, and (7) policyholder dividend reimbursements paid to another insurance company under a reinsurance agreement. In addition, life insurance companies are allowed other deductions generally allowable to corporate taxpayers for purposes of computing taxable income, subject to certain modifications. These modifications are generally the same as under present law.

Intercorporate dividends.—With respect to the deduction for intercorporate dividends received by a life insurance company, in general the bill continues the present-law rule of prorating the deduction between the company and the policyholders as the items of investment income are allocated between the company and the policyholders. (See the discussion of new section 812 in item h. below.) However, "100 percent dividends" (i.e., dividends that would be allowed a 100 percent deduction under sections 243 or 244, and certain dividends received by foreign corporations that would be 100 percent dividends but for the foreign recipient) are not subject to proration except to the extent they are funded with tax-exempt interest or with dividends that would not qualify as 100 percent dividends in the hands of the taxpayer. For these purposes, a distribution would be considered to be funded ratably out of tax-exempt interest, dividends that would not qualify as 100 percent dividends to the taxpayer, and all other taxable income of the distributing corporation. Also for purposes of applying the exception, multi-tiered corporate ownership arrangements cannot be used to change the character of the tax-exempt interest and dividends received in an attempt to avoid proper proration.

The rationale for this special rule is that dividends received by a life insurance company parent from a subsidiary represent the earnings of the subsidiary. To the extent they are distributions of fully taxable income, these earnings have already been taxed at the subsidiary level. Including them in gross investment income would have the implicit effect of taxing these earnings a second time through operation of the proration formula. However, to the extent these earnings are distributions of tax-exempt income, they have not been taxed and should be subject to proration. Without this rule, a parent life insurance company could avoid proration of tax-exempt interest by having a subsidiary own all of its tax-exempt obligations. The subsidiary would not be taxed on this income which it could distribute to the parent as dividends. However, the proposed rule would avoid this result by having gross investment income include dividends received from a subsidiary to the extent that such dividends are distributions of tax-exempt interest or of dividend income that would not be 100 percent deductible if received directly by the taxpayer. The bill also prevents a group from using multi-tier corporations to pass dividends comprised of tax-exempt income up to a parent life insurance company.

The committee is aware that, as under present law, the proration of tax-exempt income may also be avoided by distributing surplus in the form of dividends to a parent (nonlife insurance) company that could invest in tax-exempt income. This possibility is less troublesome than that of placing assets in a subsidiary because assets of a parent do not contribute to a company's surplus while assets of a subsidiary do. This difference effectively places a limitation on the amount of assets which a company may pay as dividends to a parent without jeopardizing its ability to do business under State law.

Reimburseable policyholder dividends.—The specific deduction for policyholder dividend reimbursements paid by a life insurance company to another insurance company under a reinsurance agreement was originally adopted under TEFRA, as was the rule that all policyholder dividends paid by an insurance company directly insuring the policyholder are to be treated as paid by that company. The bill adopts both provisions.[9] The bill clarifies, however, that these reimbursements for policyholder dividends are expenses of the reinsuring company (the reinsurer) and are not policyholder dividends as defined for tax purposes. Also, the bill specifically uses the term "reimbursable dividends" both in referring to the deduction allowed therefor, and in referring to the inclusion of such dividends in income by the direct writer of the insurance, in order to clarify that such dividends are deductible and includible in income on an accrual accounting basis.

The special life insurance company deduction (new sec. 806(a))

A life insurance company is allowed a deduction for any taxable year of 25 percent of its "tentative life insurance company taxable income" (tentative LICTI) over the amount of the company's small life insurance company deduction. The committee believes that although the bill provides for the proper reflection of the economic income of a life insurance company without this deduction, some adjustment is necessary to avoid suddenly imposing a substantially increased tax burden on life insurance companies. Under present law, a life insurance company is able to defer or avoid taxation on a substantial portion of its current income, and thus this provision ameliorates the hardship that might otherwise result from a sudden, substantial increase in a company's tax base and insures that life insurance companies remain competitive with other tax-favored and tax-exempt financial intermediaries (e.g., banks, thrift institutions, self-insurance trusts, Blue Cross-Blue Shield, etc.).

As indicated above, the tax base for the special life insurance company deduction is tentative LICTI. Generally, a company's tentative LICTI is its life insurance company taxable income determined without regard to (1) the special life insurance company and small life insurance company deductions, and (2) any items (income or loss) attributable to any noninsurance business.

Under this provision, the special life insurance company deduction applies only with respect to income resulting from a company's life insurance business. Thus, gains and losses arising from a noninsurance business operated by a life insurance company will neither increase nor decrease the amount of the company's special life insurance company deduction (or small life insurance company deduction). For these purposes, noninsurance business means any trade or business which is not an insurance business. Generally, insurance business refers to the business activity of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with investment activities and administrative services that are required to support or are substantially related to the contracts issued or reinsured by the taxpayer. Thus, for example, if a life insurance company ran a manufacturing business directly (rather than owning stock in the company), any income and deduction items attributable to the manufacturing business would not be taken into account in computing tentative LICTI. Likewise, if a life insurance company acted as a broker, buying and selling securities directly for the public, such activities would not be investment activities that are necessary to support contractual obligations to policyholders in the insurance business, and would be noninsurance business.

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[9] The committee also adopted an amendment to the TEFRA provisions, for taxable years 1981 and 1982 which is an exception to the reimbursable dividends rule. Reimbursable dividends paid pursuant to a reinsurance agreement entered into before June 30, 1955 by a life insurance company to reinsure their accident and health policies, pursuant to the direction of the National Association of Insurance Commissioners, will be treated as policyholder dividends of the reinsurer.

The concept of noninsurance business is further modified by a provision that any business that is not an insurance business but is of a type traditionally carried on by life insurance companies for investment purposes is to be treated as insurance business. This modification recognizes that life insurance companies have traditionally engaged in certain types of income-producing activities as investments, either directly or though partnership interests, that could be viewed as noninsurance business activities. Examples would be the ownership and rental of real estate and the development and sale of real estate. Likewise, life insurance companies have traditionally offered administrative services on certain deposit contracts or contracts without any insurance guarantees. Such noninsurance business activities will be treated as insurance business for purposes of computing tentative LICTI.

The application of this rule can be illustrated as follows. If a life insurance company (not eligible for any small life insurance company deduction) has $100X of net income from its insurance business and $10X of net income from its noninsurance business, the amount of its special life insurance company deduction is $25X (i.e., 25 percent of $100X). If, instead, the company has $100X of net income from its insurance business and a $10X loss from its noninsurance business, the company's deduction still would be $25X (i.e., 25 percent of $100X). The purpose of this provision is to limit the tax rate adjustment to life insurance income and protect noninsurance businesses from unfair competition from life insurance companies that enter into noninsurance businesses.

In addition, the bill limits the amount of the special life insurance company deduction by treating all life insurance companies that are members of the same controlled group as one company whether such companies join in the filing of a consolidated return or file separate returns. The special life insurance company deduction is then allocated proportionally among the life insurance company members of such group with a positive tentative LICTI. For these purposes, the term controlled group is defined generally by reference to section 1563. In prescribing this rule, it is recognized that the gain or loss of any life insurance company member will be reflected in the computation of the affiliated group's tentative life insurance company income even if that particular member is not allowed to join in the consolidated return because it has not been a member of the affiliated group for the required time or is a foreign corporation. In this situation, a loss of such a company would reduce the special life insurance company deduction even though the loss would not actually reduce consolidated tentative LICTI. Later, if the ineligible member can join in the consolidated return, a carryover of the earlier loss might again reduce such tentative LICTI, along with the group's special deduction for that year. To eliminate this potential double reduction, the bill provides special regulatory authority for the Secretary of the Treasury to prescribe proper adjustments to be made in the application of this provision so that a loss from operations of any member of a group will reduce the tentative LICTI of such group only once.

Also, a special rule applies to corporations joining in the filing of a consolidated Federal income tax return. Under this rule, no items of income or loss of nonlife members of the affiliated group joining in the return are taken into account for purposes of computing tentative LICTI.

The small life insurance company deduction (new sec. 806(b))

Under the bill, small life insurance companies are allowed an additional special deduction that is not available to other taxpayers. This deduction also is based on tentative LICTI, and applies before the special life insurance company deduction.

The amount of the deduction is 60 percent of so much of tentative LICTI for such taxable year as does not exceed $3,000,000, reduced by 15 percent of the excess of tentative LICTI over $3,000,000. For example, if a small life insurance company has tentative LICTI of, $2,900,000, its small life insurance company deduction would be $1,740,,000 (i.e., 60 percent of $2,900,000). If the company's tentative LICTI is, $3,900,000, its small life insurance company deduction would be $1,665,000 (i.e., 60 percent of $3,000,000 reduced by 15 percent of the excess of $3,900,000 over $3,000,000). Under this provision, the maximum benefit that can be enjoyed by a small company is $1.8 million, and a company with a tentative LICTI of $15 million or more would not be entitled to any small company deduction. For these purposes, the term tentative LICTI has the same meaning as it does for purposes of the special life insurance company deduction, that is, it does not include any items (income or loss) attributable to a noninsurance business.

As in the case of the special life insurance company deduction, the small life insurance company deduction is computed by treating all life insurance companies that are members of the same controlled group as one company whether those companies join in the filing of a consolidated return or file separate returns. The small life insurance company deduction is then allocated among the life insurance company members of such group in proportion to each such member's separate positive tentative LICTI.

The small life insurance company deduction is only allowable to companies with gross assets of less than $500,000,000. Except for real property and stock, which are taken into account at fair market value, the amount attributable to an asset is the adjusted Federal income tax basis of such asset for purposes of determining gain. Interests in partnerships or trusts are not treated as assets of the company. Rather, a company is treated as owning its proportionate share of the assets of any partnership or trust in which it has an interest. These rules are intended to prevent companies from holding assets in a noncorporate entity in order to qualify for the small company deduction. With some modifications, this approach for valuing assets is consistent with the valuation of assets of life insurance companies for tax purposes under present law.

The asset qualification for the small company deduction is determined on the basis of a controlled group as defined in section 1563. The committee believes that this controlled group rule, which takes into account both insurance and noninsurance businesses, is appropriate because the small companies that require added special treatment are those that cannot look to a parent corporation or affiliate with substantial assets for capital during their growth period. Similarly, the restriction will prevent the small company deduction from creating an incentive for large noninsurance businesses to take over small independent insurers.

As in the case of the special life insurance company deduction, the committee believes that, without this provision, the bill provides for the proper reflection of taxable income. Nonetheless, the committee recognizes that small life insurance companies have enjoyed a tax-favored status for some time, and believes that it would not be appropriate to dramatically increase their tax burden at this time.

c. Policyholders surplus accounts (new sec. 815)

Present Law

As noted above, present law permits stock life insurance companies to defer the tax on 50 percent of their gain from operations in excess of their taxable investment income. The deferred income is added to a policyholders surplus account, along with amounts deducted for nonparticipating contracts and group life and accident and health insurance contracts. Amounts in the policyholders surplus account are taxed only when distributed by the company to its shareholders. To determine whether amounts have been distributed, a company must maintain a shareholders surplus account which generally includes the company's previously taxed income and certain nontaxable items that would be available for distribution to shareholders. Distributions to shareholders are treated as being first out of the shareholders surplus account, then out of the policyholders surplus account and finally out of other accounts.

Explanation of Provision

In general, the bill eliminates any further deferral with regard to income for 1984 and later years. Although companies will not be able to enlarge their policyholders surplus account after 1983, they will not be taxed on previously deferred amounts unless they are treated as distributed to shareholders or subtracted from the policyholders surplus account under rules comparable to those provided under the 1959 Act, but which reflect the basic changes in the tax structure under the bill.

The bill provides that any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company will be subject to tax at the corporate rate in the taxable year of the distribution. For these purposes, the term distribution is intended to include actual and constructive distributions. See *Union Bankers Insurance Co.*, 64 T.C. 807 (1975). Although new amounts will not be added to the policyholders surplus account, a shareholders surplus account must be continued in order to maintain a record for tax purposes of previously taxed and other amounts that are eligible for distribution before a distribution is made from the policyholders surplus account. Thus, the bill provides for appropriate additions to the shareholders surplus account based on the new provisions adopted and replacing the 1959 Act.

Specifically, for each taxable year, the excess of the sum of the following amounts over the taxes paid for the year will be added to the shareholders surplus account: (1) LICTI (determined without regard to any distributions from the policyholders surplus account); (2) the special life insurance company deduction; (3) the small life insurance company deduction; (4) the deduction allowed the company for intercorporate dividends received; and (5) excluded tax-exempt interest. In developing this list of additions to the shareholders surplus account under the new provisions, additions for certain capital gains and the policyholders' share of the intercorporate dividend deduction were not included in order to prevent some of the double counting that existed under the 1959 Act. Also, the addition for the small company deduction of $25,000 under the 1959 Act was eliminated as was that deduction under the new tax structure. On the other hand, under the bill, the amount of the new special life insurance company deduction of 25 percent of tentative LICTI is added to the shareholders' surplus account, along with the new small life insurance company deduction. These new items may substantially increase annual additions to the shareholder surplus account, in comparison with present law, and thus may more than offset the modifications made to the account to eliminate double counting.

Aside from the changes indicated for maintaining the shareholders surplus account, the bill generally adopts the provisions of the 1959 Act with respect to the phase III tax. Thus, the ordering rules for distributions and subtractions, the requirement that distributions from the policyholders surplus account be "grossed up" for taxes payable thereon, and limitations on the size of the policyholders surplus account as a percentage of reserves, in general, will continue to apply. In so continuing these provisions, the committee intends that any reference to reserves be to reserves computed in a manner consistent with the provisions of the 1959 Act.

d. Deductions with respect to reserves (new secs. 807 and 817)

Present Law

A life insurance company is allowed to deduct (or exclude from income) increases in its year-end reserves over those for the prior year. Under present law, there are two elements to the deduction for reserves. First, for purposes of computing its taxable investment income, a life insurance company can exclude from its investment yield (i.e., gross investment income less investment and similar expenses) the policyholders' share of that investment yield.

Second, for purposes of computing gain and loss from operations, a life insurance company can deduct increases in reserves allocable to premium income (i.e., increases in reserves, adjusted to not include required interest that is credited to its reserves and excluded in the computation of taxable investment income). A life insurance company's tax reserves are based on its reserves for State regulatory purposes (i.e., statutory reserves) and, as a general rule, a company's deduction reflects an increase in its statutory reserves over its statutory reserves for the prior year.

Under present law, life insurance reserves must be (1) required under State law, (2) computed or estimated on the basis of recognized mortality or morbidity tables and an assumed rate of interest, and (3) set aside to mature or liquidate future claims under life, annuity, or noncancellable accident and health insurance contracts.

Statutory reserves are calculated under a preliminary term method or the net level premium method. Generally, under a preliminary term method, first year expenses (e.g., commissions) are funded out of the premiums for the first year, and only the excess of net premiums reduced by such expenses is available to fund reserves. Under the net level method, the first year expenses are treated as funded out of net premiums over the life of the contract. Companies using this method for State regulatory purposes have larger reserves in the early years of a contract than companies using the preliminary term method. However, because expenses not funded out of premiums must be funded out of surplus, the net level method is, for all practical purposes, not generally available to companies with limited amounts of surplus.

A life insurance company is allowed to revalue its preliminary term reserves for tax purposes to eliminate a disparity that would otherwise result in the tax treatment of life insurance companies with greater amounts of surplus and companies with smaller surplus accounts. Reserves computed for statutory purposes on a preliminary term basis may be revalued to a net level premium basis using either an exact revaluation method or an approximate revaluation. Reserves recomputed under the approximate formula (as modified by TEFRA) are revalued by increasing such reserves by (1) $19 per $1,000 of insurance in force for other than term insurance, less 1.9 percent of the reserves under such contracts, and by (2) $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of the reserves under such contracts. The approximate revaluation formula may result in greater reserves than actual net level premium reserves or reserves recomputed using an exact revaluation method.

Under present law, if as of the close of any taxable year the basis for determining the amount of any increase or decrease in reserves differs from the basis for such determination as of the close of the preceeding taxable year, any resulting income or loss is taken into account ratably over a 10-year period.

In addition to the rules described above which apply to life insurance contracts, other rules provide for unearned premium and unpaid loss reserves for accident and health insurance contracts. Under these rules, unpaid losses may be estimated and reserved for on a nondiscounted basis. For purposes of determining the amount of the deduction for the addition to the unearned premium reserve, gross premiums are considered to be earned pro rata over the life of the contract.

Explanation of Provisions

In general, life insurance companies are allowed a deduction for a net increase in reserves and must take into income any net decrease in reserves. Unlike their treatment under the 1959 Act, the deduction for increases in reserves would take into account increases due to both premiums and assumed interest credited to the reserves. In general, the net increase or net decrease in reserves, is computed by comparing the closing balance for reserves to the opening balance of the reserves, where the closing balance of the reserve becomes the opening balance for the following year.

Also, in computing the net increase or net decrease in reserves, the closing balance of the reserve items is reduced by the policyholders' share of tax-exempt interest. This continues the view under present law that a life insurance company's reserve liability to its policyholders in effect entitles the policyholders to a pro rata portion of each item of investment income.

Reserves taken into account

In computing the net increase or net decrease in reserves, the bill specifies that six items, which are all reserves or in the nature of reserves, be taken into account. These are (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations which are obligations under insurance and annuity contracts which do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts;[10] (5) premiums received in advance and liabilities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are held for retired lives, premium stabilization, or a combination of both.

The six items specified in the bill generally are the same items as under present law. However, the bill requires that the amount of the contingency reserves held for retired lives and premium stabilization be reasonable in relation to the amount of coverage provided by, and the loss experience suffered by, the company with respect to the underlying group contract. Also, the bill requires that the discount rate used by the companies for a reserve amount for an insurance and annuity obligation that does not involve life, accident, or health contingencies be the higher of the prevailing State assumed interest rate or the interest rate assumed by the company in determining the guaranteed benefits. These rates are to be determined when the obligation first ceases to involve life, accident, or health contingencies.

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[10] The investment portion of any life insurance contract which fails to meet the definition of a life insurance contract under section 7702 is treated as a reserve under section 807(c)(4).

The statutory listing of items to be taken into account in computing the net increase or net decrease in reserves refers to life insurance reserves "as defined in section 816(a)." Section 816(a) requires a proper computation of reserves under State law for purposes of qualifying as a life insurance company. This cross reference is intended merely to identify the type of reserve for which increases and decreases should be taken into account and is not intended to superimpose the requirement of proper computation of State law reserves for purposes of allowing increases in such reserves to be recognized. Conceivably, a similar reference in present law required proper computation under State law in order for deductions to be allowed, because present law used the statutory reserves as the basis for measuring deductions and income for tax purposes. The bill, however, takes a new approach by prescribing specific rules for computing life insurance reserves for tax purposes, and as a consequence, the amount of the deduction allowable or income includible in any tax year is prescribed regardless of the method employed in computing State statutory reserves.

Computation of reserves

For purposes of determining life insurance company taxable income, the bill provides that the life insurance reserves for any contract shall be the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules. In no event will the amount of the tax reserves at any time exceed the amount of the statutory reserves. The net surrender value is the cash surrender value reduced by any surrender penalty except that any market value adjustment required on surrender is not taken into account. Generally, the comparison of the net surrender value of a contract and the Federally prescribed reserves for the benefits under the contract is made on a aggregate benefit basis; however, the comparison may be made on a benefit-by-benefit basis if the benefit is a qualifying supplemental benefit or qualifying substandard risk (see discussion below on special rules). Also, the comparison of contract cash surrender values and Federally prescribed reserves can be done on a group basis (i.e., grouping contracts that are identical as to plan of insurance, date of issue, age of issue, etc.) or on an individual contract basis.

The bill requires that, in computing the Federally prescribed reserve for any type of contract, the tax reserve method applicable to that contract must be used, along with the prevailing State assumed interest rate and the prevailing commissioners' standard tables for mortality or morbidity. The prescribed rules for computing tax reserves are intended, generally, to allow companies to recognize at least the minimum reserve that most States would require them to set aside, but no more unless the net surrender value is greater. To avoid State-by-State variations, the rules prescribed in the bill are based on the general guidelines recommended by the National Association of Insurance Commissioners (NAIC) and adopted by a majority of the States.

Reserve method

With respect to the reserve method to be used, the bill prescribes specific tax reserve methods for particular types of contracts. For life insurance contracts, the prescribed method is the applicable Commissioners' Reserve Valuation Method (CRVM) in effect when the contract is issued. This is the date that appears on the policy form. For annuity contracts, the prescribed method is the applicable Commissioners' Annuities Reserve Valuation Method in effect when the contract is issued.[11] For noncancellable accident and health insurance contracts, a 2-year full preliminary term method is required.[12] Finally, for all other contracts, the reserve method prescribed by the NAIC or, if no method is so prescribed, a method consistent with whichever of the prescribed methods that would be most appropriate for the contract. An example of a life insurance contract not presently covered by an NAIC prescribed method is a universal life insurance contract. Until NAIC prescribes an appropriate method for universal life insurance, reserves should be computed on a method consistent with CRVM. Also, the committee understands that the NAIC has not prescribed a method for contracts issued by assessment companies in Texas (i.e., either mutual assessment companies or stipulated premium companies), because such life insurance companies generally are not found outside of Texas. Under Texas law, reserves for such policies are computed on a half-year full preliminary term method and such method should be considered to be consistent with CRVMs prescribed by the NAIC.[13]

Interest rates and mortality tables

With respect to the assumed interest rate and the mortality or morbidity tables to be used in computing the Federally prescribed reserve, the bill looks to the "prevailing view" of the States. A view is considered to be a prevailing view if it is recognized by at least 26 States when the contract is issued.[14] Thus, the "prevailing State assumed interest rate" means, for any contract, the highest assumed interest rate permitted to be used in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning of the calendar year in which the contract is issued in at least 26 States. If the highest assumed interest rate is actually determined by the States during the year but declared effective as of the beginning of the calendar year, such rate would be considered so effective for tax purposes, also. For nonannuity contracts, the issuing company may elect, on a contract by contract basis, to use the prevailing interest rate from the preceding calendar year. In determining the highest assumed rates permitted in at least 26 States, each State should be treated as permitting the use of every rate below its highest rate. Also, the highest State assumed interest rate referred to in the bill is the highest permitted to be used in computing reserves without taking into account any limitations that might be imposed by States if a different rate is assumed for computing cash surrender values under standard nonforfeiture laws.

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[11] There is a special rule for a company domiciled in a State which, in determining minimum reserves for an annuity contract for State purposes, does not reduce the reserves for surrender charges. Section 217(c) of the bill provides that if a State has continuously pursued this practice since September 27, 1983, then any life insurance company domiciled in that State may adjust its Federally prescribed reserves (under section 807(d)(2)) by taking into account the reasonable surrender charges.

[12] There is also a special rule which allows a company to use the net level premium reserve method for such reserves for tax purposes, if the company was using that method for such reserves as of December 31, 1982, and continues to do so for annual statement purposes.

[13] An exception from the general mortality and morbidity tables requirements for reserves for life insurance contracts issued by assessment companies is also provided as a nonCode amendment. These companies may use the table used for State law purposes if that mortality and morbidity table was developed by taking into account the particular experience of those companies and was in existence and in use by 1965. Further revisions of such unique tables would be allowed for tax purposes only if the table is revised in a manner consistent with the way in which the original table was developed. Finally, there is a nonCode amendment that allows mutual assessment companies in Texas to use their statutory reserves for tax purposes. (sec. 217(g) of the bill).

[14] In the case of reinsurance, the issue date that should be referred to for these purposes is that of the underlying policies and not the date of the reinsurance contract.

Like the prescribed interest rate, the prevailing commissioners' standard tables for mortality or morbidity to be used for computing the Federally prescribed reserves are, with respect to any contract, the most recent tables prescribed by the NAIC and permitted to be used for that type of contract in computing reserves under the laws of at least 26 States when the contract is issued. If a table becomes a prevailing commissioners' standard table during a calendar year, the table shall be such as of the beginning of the calendar year. Generally, when mortality and morbidity tables are being updated and adopted by the States, companies will have three full years after a particular set of tables becomes the prevailing view of the States before such table becomes mandatory for computing reserves for tax purposes. For example, it is the understanding of the committee that the 1980 C.S.O. tables for life insurance contracts have now been adopted by at least 26 States. Thus, although companies will be able to use either the 1958 C.S.O. tables or the 1980 C.S.O. tables for taxable years 1984, 1985, and 1986 for computing tax reserves, the 1980 C.S.O. tables will have to be used for contracts issued after 1986. Companies may adjust the prevailing commissioners' standard tables, as appropriate, to reflect risks incurred under the contract if such risks are not otherwise taken into account. For example, a company may use an appropriate multiple of a table to reflect the substandard classification of particular insureds because of poor health. Also, adjustment to the tables may be appropriate to reflect the risks involved in writing term insurance on individuals for whom the company requires no evidence of insurability (that is, if the company does not underwrite the risks);[15] or because the insureds reside in a foreign country known to be experiencing civil strife.

The bill also provides special rules for existing contracts where standard tables are not available or where multiple tables (or projections) are available. Generally, if there is no prevailing commissioners' standard table applicable to a contract when it is issued, the table used for purposes of computing the Federally prescribed reserve shall be determined under Treasury regulations. However, for contracts issued before 1948 (when the use of commissioners' standard tables was first required), the mortality or morbidity tables used for State law purposes can be used in recomputing all reserves for tax purposes as of January 1, 1984, and thereafter in computing the Federally prescribed reserve. The bill also specifically provides that, if there are multiple mortality and morbidity tables (e.g., projections of the standard table) that meet the definition of the prevailing commissioners' standard table, the table that generally yields the lowest reserve must be used in computing the Federally prescribed reserve.

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[15] For example, States have recognized that some adjustment is appropriate to the standard table for computing adequate reserves on credit life insurance.

Change in computing reserves

The present law rule allowing income or loss resulting from a change in the method of computing reserves to be taken into account ratably over a 10-year period is retained under the bill.

Special rules

In addition to the above described rules for computing the Federally prescribed reserves, the bill provides some special rules for life insurance reserves under pension plan contracts, group contracts, certain supplementary benefit provisions, substandard risks, and contracts issued by foreign branches of domestic life insurance companies.

Pension plan and group contracts

For purposes of computing the amount of life insurance reserves for pension plan contracts, the net surrender value of a contract is deemed to be an amount equal to the balance in the policyholder's fund (determined without regard to any market value adjustment). The term "policyholder's fund" refers generally to any experience fund, experience accumulation or asset share allocable to the contract.

For purposes of computing the Federally prescribed reserve for any group contract, the date the contract is issued is generally the date as of which the master plan is issued. However, if a benefit is guaranteed to a plan participant after such date, the company must take into account the date as of which the benefit is guaranteed in computing its reserves.

Supplemental benefits

Under the bill, the amount of the life insurance reserve for certain enumerated supplemental benefits is the statutory reserve. The committee believes that, due to the de minimis nature of the enumerated supplemental benefit reserves, economic distortions caused by using statutory reserves would be minimal. The supplemental benefits listed are any (1) guaranteed insurability benefit,[16] (2) accidental death or disability benefit,[17] (3) convertibility benefit, (4) disability waiver benefit, or (5) any other benefit prescribed by regulations, if such benefit is supplemental to a contract for which there is a policyholder reserve item taken into account for taxable income purposes. The reserve for any other benefit provided for under the contract and not listed above, whether or not such a benefit is considered supplemental under State law, must be computed using the Federally prescribed method (as described in section 807(d)).

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[16] The term "guaranteed insurability benefit" is intended to include guaranteed annuability benefits.

[17] Because of the intended *de minimis* nature of the listed supplemental benefits,a disability income benefit provision (other than one that provides for income payments to carry the premiums of the policy or some other incidental expenses of the insured) is not intended to be construed as a supplemental benefit.

If a supplemental benefit is a "qualified supplemental benefit", the life insurance reserve for such benefit shall be computed separately as though such benefit were under a separate contract. A qualified supplemental benefit is a supplemental benefit as listed in the bill, if there is a separately identified premium or charge for such benefit and any cash value (i.e., net surrender value) under the contract attributable to any other benefit is not available to fund such supplemental benefit. The use of any loan provision to pay premiums or charges due for the supplemental benefit is not intended to be construed as making any net surrender value available for the purposes of this provision.

For example, if a contract provides for a qualified supplemental benefit (e.g., accidental death or disability) and the net surrender value of the contract is $4,000 and the reserves are $3,800 for the basic death benefit and $50 for the supplemental benefit, the total reserve for tax purposes will be $4,050 if none of the net surrender value is attributable to the qualified supplemental benefit. In essence, the supplemental benefit is considered a separate contract and the reserve is computed as the greater of the net surrender value or the tax reserve. If, however, the supplemental benefit was not a qualified supplemental benefit, the total reserve for tax purposes would be $4,000 because the supplemental benefit would not be considered a separate contract and the amount of the life insurance reserve for the contract is the greater of the net surrender value (i.e., $4,000) or the Federally prescribed reserves amount (i.e., $3,800 + $50).

Substandard risks

The amount of life insurance reserve for any "qualified substandard risk" will be computed as if under a separate contract. A substandard risk is a qualified substandard risk if (1) the insurance company maintains a separate reserve for such risk, (2) there is a separately identified premium charge for such risk, (3) the amount of the net surrender value under the contract is not increased or decreased by reason of such risk, and (4) the net surrender value under the contract is not regularly used to pay premium charges for such risk. For example, the committee expects that regulations could provide that a provision for the systematic borrowing based on the net surrender value of the contract to pay both the basic premium and the substandard charge will be considered to disqualify the substandard risk in certain situations. However, loan provisions that are not actually used on a regular and automatic basis would not result in disqualification of the substandard risks.

The amount of the life insurance reserve determined for any qualified substandard risk will in no event exceed the sum of the separately identified premium charges for such risk plus interest, less mortality charges. The aggregate amount of insurance in force under contracts to which these special rules for substandard risks can apply cannot exceed 10 percent of insurance in force (other than term insurance) under life insurance contracts of the company. The substandard classification of any insurance in force in excess of 10 percent can only be taken into account through an appropriate adjustment to the prevailing commissioners' standard table in computing the Federally prescribed reserve. Also, if a company computes a separate substandard reserve under the qualified substandard risk provision, the mortality assumption for purposes of computing the reserve for the basic benefit cannot take into account any substandard risk factors.

Reserves under foreign law

There is a special rule which allows domestic life insurance companies to recognize, in lieu of the Federally prescribed reserve, the minimum reserve required by the laws, regulations, or administrative guidance of the regulatory authority of a noncontiguous foreign country if (1) the reserves arise out of life, accident or health insurance contracts issued to residents of the foreign country and (2) the foreign country requires the domestic company (as of the time it began operations in the foreign country) to operate in such country through a branch. The reserve cannot exceed the net level reserve for a contract as determined using NAIC standards and the interest rates and mortality tables used in the contract.

Variable contracts (new sec. 817)

The bill continues to provide the special rules as under present law for variable annuities and contracts with reserves based on segregated asset accounts and extends those rules to variable life insurance contracts. Thus, with respect to any variable contract, the reserve items taken into account at the close of the taxable year for purposes of determining net increases or net decreases must be adjusted by subtracting any amount attributable to appreciation in value of assets or by adding any amount attributable to depreciation. Such adjustments for appreciation or depreciation are to be made whether or not the company has disposed of the assets during the taxable year.[18] This adjustment in computing the annual increase or decrease in reserves for variable contracts results in the capital gain or loss being recognized and taxed at both the company level and the policyholder level, since no adjustment is made in either the company's basis or the policyholder's investment in the contract. The committee believes this current capital gains tax should be retained in order to equalize tax treatment of insurance products based on investment funds and direct investment in such funds. In the case of "pension plan contracts" (i.e., contracts that are issued as part of a qualified pension plan) the company's basis in the assets underlying such contracts is adjusted for appreciation or depreciation to the extent the reserves are adjusted. Thus, in these cases the corporate level capital gains tax is eliminated. The definition of pension plan contracts is the same under the bill as under present law except that the phrase "purchased under contracts" is eliminated since it was considered unnecessary (new sec. 818(a)).

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[18] In addition to the adjustment of reserves for variable contracts, an adjustment is provided for any appreciation or depreciation during a year affecting deductions for death claims, etc., under section 805. This adjustment will apply only to the extent of such appreciation or depreciation, and not in the greater amount that such appreciation or depreciation affects death benefits. Thus, if under a variable life insurance contract, appreciation in the value of separate account assets of $100 increased death benefits by $200, the amount of the adjustment to death benefits on account of this provision is $100.

The bill also continues the separate accounting requirements under present law for various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to variable contracts. For example, with respect to variable contracts, the company's share of dividends received, and the policyholders' share of tax-exempt interest (which reduces the closing balance of the reserves), will be determined with reference to the income and deduction items attributable to the underlying separate account. Likewise, the equity base of the separate account will be determined under the separate accounting requirement and aggregated with the company's average equity base for its general account business.

e. Policyholder dividends (new secs. 808 and 809)

Present Law

In general, under present law, policyholder dividends are dividends and similar distributions to policyholders. Interest paid and return premiums are not policyholder dividends. This statutory language has been expanded in regulations so that the term policyholder dividends generally refers to amounts returned to policyholders that are not fixed in the contract and depend on the experience of the company or the discretion of management. However, taxpayers have taken the position that the term does not include excess interest (i.e., amounts in the nature of interest that are paid or credited to policyholders and are determined at a rate in excess of the rate used under the contract for purposes of computing the company's reserve deduction) even though such amounts are not fixed in the contract but depend upon the experience of the company or the discretion of management.

Under present law, policyholder dividends paid by mutual and stock life insurance companies are deductible at the company level. Special rules apply, however, to limit the amount of this deduction. Under the permanent provisions of the 1959 Act the deduction for policyholder dividends (and certain other special deductions) is limited to the excess of gain from operations over the taxpayer's taxable investment income plus a statutory amount of $250,000. Under temporary provisions added to the Code in TEFRA and applicable in 1982 and 1983, the deduction was limited to either (1) an amount computed under the 1959 Act rule with the $250,000 statutory amount increased to $1 million, phasing down to zero as the sum of the company's policyholder dividends and other special deductions increases from more than $4 million to $8 million, or (2) an amount equal to the statutory amount (as modified), plus 100-percent of dividends on pension business, plus 77-1/2 percent of nonpension policyholder dividends for mutual companies (85 percent for stocks). Under present law, policyholder dividends are accounted for on a reserve basis, and a company is allowed to deduct additions to its policyholder dividend reserves for dividends that are payable during the year following the taxable year.

Explanation of Provisions

As under present law, the bill allows a deduction for dividends or similar distributions to policyholders. The bill departs from present law, however, in that the amount of the deduction for any taxable year is the amount of policyholder dividends paid or accrued during the taxable year rather than the amount of the increases in the reserves for policyholder dividends that are payable during the year following the taxable year. Under the fresh start transitional rule, this change from a reserve to an accrual method is not to be treated as a change in a method of accounting. Thus, no income or loss is to be recognized with respect to amounts in existing policyholder dividend reserves.

Policyholder dividends defined (new sec. 808)

The bill adopts a broad definition of the term policyholder dividends to include any distribution to a policyholder that is the economic equivalent of a dividend. Thus, in addition to any amount paid or credited to policyholders (including an increase in benefits) when the amount is not fixed in the contract but depends on the experience of the company or the discretion of management, the term policyholder dividends specifically includes excess interest, premium adjustments, and experience-rated refunds. Thus, the bill corrects a possible deficiency of present law which may permit companies to avoid the limitations on policyholder dividends through the use of excess interest and experience-rated refund products rather than traditional dividend paying products.

The term excess interest means any amount in the nature of interest that is paid or credited to a policyholder and determined at a rate in excess of the prevailing State assumed interest rate for the contract (i.e., the rate used under the bill for purposes of determining the amount of the company's Federally prescribed reserve under the rules contained in new section 807(d)). Amounts in the nature of interest include all amounts paid for the use of money regardless of the particular designation adopted by the payor or payee. Thus, amounts in the nature of interest include interest payments with respect to amounts left on deposit and amounts paid in lieu of interest such as in the case of origination or service fees. Similarly, amounts in the nature of interest include amounts calculated as interest such as the increase in reserves attributable to assumed or guaranteed interest rates rather than premium contributions. Thus, for example, any increase in the cash surrender value of a contract above that which would result if the prevailing State assumed interest rate were used to compute the increase is treated as excess interest. The term premium adjustment means any reduction in the premium under an insurance or annuity contract which, but for such reduction, would have been required to be paid under the contract. If no premium amount is fixed in the contract, variations in premiums paid during the course of the contract are not considered premium adjustments. Further, a change in the amount of a premium that is attributable to the insurability of the insured is not considered a premium adjustment. Finally, the term experience-rated refunds means any refund or credit based on the experience of the contract or group involved. Thus, for example, if a company sells a group policy to an employer covering the lives of its employees and the premiums received exceed the sum of the claims paid and other expenses, any refund of such excess is an experience-rated refund. The bill also adopts the general rule that any policyholder dividend that increases any of the benefits payable under the contract (including the cash value), or reduces the premium otherwise required, is treated as paid to the policyholder and returned by the policyholder to the company as a premium.

Reduction of certain deductions of mutuals (new sec. 809)

Although the general rules and definitions relating to policyholder dividends apply to stock and mutual life insurance companies alike, the amount of the deduction for mutual companies is reduced by an amount referred to in the bill as the "differential earnings amount." If the differential earnings amount exceeds the allowable deduction, then such excess will reduce the closing balance of the company's reserves. This reduction reflects the committee's recognition that, to some extent, policyholder dividends paid by mutual companies are distributions of the companies' earnings to the policyholders as owners.

Because mutual companies' policyholders are also the owners of the enterprise, policyholder dividends paid to them are distributions from the company that are a combination of price rebates, policyholder benefits and returns of company profits. Although there is no precise way to segregate a policyholder dividend or other payment into these various components, the committee believes that it is valid to conclude that profit oriented enterprises tend to distribute earnings to their owners in amounts that are proportional to the owners' equity in the business. Thus, the committee believes that the portion of a policyholder dividend that is a distribution of earnings can be measured as a percentage of the mutual company's equity (the "average equity base"). To determine the appropriate percentage of the equity base, the after dividend rates of return on equity for both stock and mutual companies were examined, and it was determined that the average pre-tax return on equity of mutual companies falls below that for a comparable group of stock companies. The committee believes that this difference is attributable to distribution by mutual companies of earnings to their owners.

Under the bill, this theoretical approach to identifying ownership distributions by a mutual company is given effect by means of a reduction in the policyholder dividends deduction by a "differential earnings amount". This amount is computed by multiplying the company's average equity base for the taxable year by the "differential earnings rate" for the taxable year. The differential earnings rate is the excess of the "imputed earnings rate" over the "average mutual earnings rate". As explained below, the "imputed earnings rate" is set in the Code (and subsequently adjusted) to provide comparable treatment for stock and mutual companies.

Imputed earnings rate

The imputed earnings rate for 1984 is 16.5 percent. For taxable years beginning after 1984, the imputed earnings rate will be an amount which bears the same ratio to 16.5 percent as the current stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock life insurance companies for the three years preceding the taxable year) bears to the base period stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock companies for 1981, 1982, and 1983).

The committee anticipates that this 16.5-percent rate will result for 1984 in the mutual segment of the industry bearing 55 percent of the aggregate industry tax burden. The committee believes that this is appropriate in the light of a number of factors including the historic allocation of the industry's tax burden, the relative percentages of assets held by the stock and mutual segments of the industry and the difference in treatment of mutual company policyholders and stock company shareholders.[19] Since the committee believes that the 16.5-percent rate results in an appropriate allocation of the industry's tax burden for 1984, it has decided to adjust this rate in proportion to changes in the rate of return for large stock companies and not simply to replace the imputed rate with one equal to the actual rate of return of a group of stock companies in subsequent years.

The rate of return for any stock company is to be determined by the Secretary by reference to a company's statement gain from operations as a percentage of its equity base. In calculating this rate, the Secretary is to take into account companies that may be operating at a loss and, in effect, have a negative rate of return, as well as companies that are operating on a profitable basis. Further, the authority granted the Secretary to determine the rate of return includes authority to disregard or recharacterize a transaction determined by the Secretary to have been engaged in principally to manipulate the imputed earnings rate. For example, if a noninsurance parent company with a life insurance subsidiary makes a substantial capital contribution to its life insurance subsidiary during the taxable year (but such amount is not reflected in the assets at the beginning or end of the year), the Secretary would compute the rate of return for the subsidiary without taking into account the amount contributed by the parent or the income generated by such amount if the Secretary determined that the contribution was principally intended to enable the life insurance subsidiary to manipulate its rate of return. In making this determination, the Secretary would consider such factors as the existence of any nontax business purpose for the transaction and the reasonable needs of the subsidiary for capital.

A numerical average of stock earnings rates is used in order to reduce the potential impact of any manipulation of the rate by a few large stock companies. The three-year period is used to preclude the possibility of sharp rises or declines in the rate of return for the stock segment of the industry, giving the mutual companies some ability to plan for and predict tax costs for purposes of marketing their products. The 50 largest stock companies are to be determined by the Secretary of the Treasury on the basis of gross assets. For purposes of ascertaining the top 50 companies and their earnings rates, assets of a company among the 50 largest will be aggregated with assets of any affiliated life companies (i.e., affiliated groups will be treated as one company).

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[19] Earnings that are distributed by a stock company to its shareholders are included in income by the shareholders. In contrast, in the case of a mutual company, earnings that are distributed are not included in income by the policyholders.

Average mutual earnings rate

The average mutual earnings rate for any year would be the weighted average of the rates of return for mutual companies. The use of an aggregate or weighted average approach is intended to prevent manipulation by large mutual companies through payment of overly large amounts of policyholder dividends which would substantially increase the differential earnings rate and adjustment in the following year.

Average equity base

The average equity base of a stock or mutual company is the average of (1) the equity base determined as of the close of the taxable year, and (2) the equity base determined as of the close of the preceding taxable year. For purposes of computing a company's average equity base for a taxable year beginning in 1984, the equity base for 1983 will be computed under the rules contained in the bill as if the bill were in effect for such year. The term equity base means an amount equal to the statutory surplus and capital plus any nonadmitted financial assets, the excess of statutory policy reserves over tax reserves, the amount of any mandatory securities valuation reserve, the amount of any deficiency reserve or any voluntary reserve, and 50 percent of the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year. The term nonadmitted financial asset does not include due and accrued investment income reported as a nonadmitted asset, investments in office furnishings or fixtures, or agents' balances owed to the company. Thus, for example, an amount of due and accrued interest on defaulted bonds is not a nonadmitted financial asset, even though the underlying defaulted bond may be a nonadmitted financial asset. Also, in determining the excess of statutory reserves over tax reserves, the amount of statutory reserves should not include any amount attributable to deferred and uncollected premiums that have not yet been included in life insurance gross income.

Amounts included in equity under the bill would generally refer to and be valued as amounts shown on the annual statement of the company. However, a classification or characterization of an item on a company's annual statement in an attempt to avoid the requirements of the bill is to be disregarded. Thus, for example, if a company sets up a provision on its annual statement for excess interest that it will distribute in the year following the taxable year, and this provision is separate from its provision for policyholder dividends and is not adjusted for in restating annual statement reserves to tax reserves, the provision will be treated as an "other similar liability" payable in the following taxable year, requiring that 50 percent of such amount be included in the equity base.

As stated above, a company's average equity base is the average of its equity base determined as of the close of the taxable year and its equity base determined as of the close of the preceding taxable year.

Differential earnings rate

The differential earnings rate for any taxable year is based on a comparison of the adjusted imputed earnings rate and the average mutual earnings rate for the second preceding year. This rule is necessary because, for any taxable year, the Secretary will not have the data required to determine the average mutual earnings rate prior to the date a mutual company will file its Federal income tax return. However, when actual data becomes available, any difference between the average differential earnings amount for the taxable year and the average differential earnings amount for the second preceding taxable year is to be taken into account as an addition to or deduction from income (before computation of the special life insurance deduction and the small life insurance deduction) for the taxable year during which the Secretary determines the average mutual earnings rate for the prior taxable year. Because any additions to or deduction from income will be taken into account in the first year during which the actual average differential earnings rate can be recomputed, no interest payments are required. If a company ceases to be a mutual insurance company in any year, then any adjustment will have to be taken into account for the taxable year giving rise to the adjustment.

Special rules

The bill also contains some special rules or modifications. First, the equity base of any mutual life insurance company can be reduced by that portion of the equity base attributable to the life insurance business that is properly allocable to reserves or liabilities for life insurance contracts issued on the life of residents of Western Hemisphere countries that are noncontiguous to the United States. The equity that is properly allocable to such contracts is the same proportion as the reserves for such contracts bears to the total tax reserves on life insurance contracts (if that proportion is at least 1 to 20). This special equity base modification recognizes that a company may need to maintain higher levels of surplus because of the special classification or substandard nature of certain insureds living in foreign countries undergoing civil strife.

The bill also provides a 5-year transition rule for high surplus mutual life insurance companies for purposes of applying the ownership differential provision. A company is a high surplus company if its equity base to asset ratio for 1984 exceeds 130 percent of the average equity base to asset ratio of all mutual life insurance companies. A high surplus company need not apply the differential earnings rate to the excess portion of its equity base. However, in no event can the amount of any excess not taken into account exceed $50 million in 1984. The amount of any excess equity not taken into account in applying the differential earnings rate, as well as the $50 million cap, will decrease ratably each year until 1989 the entire equity base of a high surplus company is subject to the differential earnings rate.

Finally, certain modifications to the equity base are required if a mutual life insurance company owns one or more subsidiary life insurance companies. Such subsidiaries are generally treated as stock life insurance companies in computing such subsidiaries' entity level income tax liability. However, for purposes of computing the differential earnings amount, a mutual parent of a subsidiary life insurance company must include the equity of such company in its own equity base (in lieu of the stock of the subsidiary). At the same time, for purposes of determining the statement gain from operations of the mutual parent, the mutual parent would ignore any dividends it received from the subsidiary. Also, for purposes of computing the average mutual earnings rate and the imputed earnings rate, life insurance subsidiaries of a mutual life insurance company would be counted as mutual companies. If a subsidiary life insurance company is owned by more than one mutual entity and is not a member of an affiliated group, the Secretary is given regulatory authority to prescribe how proper adjustments should be made in the equity bases of mutual life insurance companies owning stock therein to carry out the general rules described above.

f. Operations loss deduction (new sec. 810)

Present Law

Generally, operations losses may be carried back to each of the 3 taxable years preceding the loss year and may be carried over to each of the 15 taxable years following the loss year. For a life insurance company that qualifies as a new company in the loss year, the 3-year carryback may be added, instead, to the 15-year carryover.

Explanation of Provision

The operations loss deduction provided in the bill is substantial the same as that in section 812 in present law and new section 810 is treated as a continuation of present law section 812. Modifications are made that will conform the definition of an operations loss deduction to the new method for determining life insurance company taxable income. In both the bill and present-law section 812, the operations loss deduction is consistent with the general treatment for a net operating loss in section 172.

The operations loss deduction for any taxable year is defined as the excess of life insurance deductions (which are described in section 804, above) over life insurance gross income (which is defined in section 803, above). The loss from operations for any taxable year may be carried back 3 taxable years and carried over 15 years, just as under present law. The 18-year carryover for a new life insurance company, as well as the definition of a new life insurance company, are unchanged from present law. Other rules, relating to the amount of carrybacks and carryovers and the election for operations loss carrybacks, also remain unchanged from present law.

No change has been made in the modifications to the computation of the loss from operations, which modifications exclude the carrybacks and carryovers of the operations loss deduction from the computation of life insurance taxable income and also relate to the limitation on the aggregate amount of dividends received deduction.

The operation of new section 810 may be illustrated by the following example. Assume that company A has the following results for 1984, 1985, and 1986:

	1984	1985	1986
Tentative LICTI	100,000	200,000	200,000
Small company deduction (sec. 806(b))	(60,000)	(120,000)	(120,000)
Special life company deduction (sec. 806(a))	(10,000)	(20,000)	(20,000)
Taxable income	30,000	60,000	60,000

Assume further that for 1987 and 1988, company A had losses from operations of $150,000 and $200,000, respectively. Under new section 810, the results will be as follows:

	1984	1985	1986
Taxable income	30,000	60,000	60,000
Small company deduction	60,000	120,000	120,000
Special life company deduction	10,000	20,000	20,000
Offset amount	100,000	200,000	200,000
1987 carryback	(100,000)	(50,000)	
1988 carryback		(150,000)	(50,000)
Taxable income after carryback	0	0	150,000

Thus, in 1986, the life insurance company taxable income for purposes of the small company deduction and the special life insurance company deduction is $150,000 after carryback of the net operating loss.

g. Accounting provisions (new sec. 811)

Present Law

Generally, under present law, all computations entering into the determination of life insurance company taxable income are to be made under an accrual method of accounting or, to the extent permitted under regulations, under a combination of an accrual method with any other recognized method other than the cash receipts and disbursements method. Except as provided in the general rule, all such computations are to be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners. This provision has been interpreted to mean the State regulatory accounting procedures should control so long as they are not inconsistent with accrual accounting rules (*Commissioner v. Standard Life and Accident Insurance Company*, 433 U.S. 148 (1977)). Also, the accounting provisions include a general prohibition against deducting an item more than once in computing taxable income.[20]

When two or more related parties (within the meaning of sec. 1239) are parties to a reinsurance agreement, present law gives the Secretary authority to allocate or recharacterize any items necessary to reflect the proper source and character of the taxable income of each related party.

Also, there was a temporary rule (adopted under TEFRA) for computing reserves on contracts where interest is guaranteed beyond the end of the taxable year; any interest which is computed at a rate which is in excess of the lowest rate assumed in the contract and is guaranteed beyond the end of the taxable year is taken into account in computing reserves as if such interest were guaranteed only up to the end of the taxable year.

Finally, under present law there are specific rules for the amortization of premium and accrual of discount on bonds and for life insurance companies with short taxable years.

Explanation of Provision

The bill retains the general rule in present law that life insurance companies must use an accrual method, or a method permitted under the regulations that combines an accrual method with another recognized method. However, the bill makes it clear that accounting methods required for State regulatory purposes apply only to the extent that they are not inconsistent with Federal tax accounting rules. The change from present law was intended to reinforce the primacy of the Federal tax rules and not impose a new method of tax accounting on life insurance companies. Thus, for example, agents' commissions paid by direct insurers would continue to be treated as sales expenses and deductible when paid, as has been allowed historically (even though they arguably might be classified as acquisition expenses to be amortized).

Although the bill continues to provide a general prohibition against any double deduction of an item, it also adopts a new rule that disallows a reserve for any item unless the gross amount of premiums and other consideration attributable to such item are required to be included in gross income. Thus, because deferred and uncollected premiums for a contract do not accrue until paid, the contractual liability related to those premiums may not be recognized until the premiums are taken into income. This provision of the bill, in effect, reverses the holding of the Supreme Court in *Commissioner v. Standard Life and Accident Insurance Co.*, 433 U.S. 148 (1977), by statutorily requiring a matching of the reserve deduction with the related income item.

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[20] Actually, the prohibition is against deducting an item more than once in computing each subpart of taxable income—taxable investment income and gain or loss from operations.

In the case of reinsurance agreements, the bill expands the reallocation authority granted Treasury. As under present law, in the case of a reinsurance agreement between two or more related persons, the Treasury can allocate among the parties and recharacterize income, deductions, assets, reserves, credits, and any other items related to the reinsurance agreement in order to reflect the proper source and character of the items for each party. Under the bill, however, related parties are defined as they are in section 482. Thus, two or more parties are related if they are organizations or entities, whether or not incorporated or affiliated, owned or controlled directly or indirectly by the same interests. Also, Treasury can use its recharacterization authority for a reinsurance agreement between unrelated parties where one of the parties to the agreement (with respect to any contract covered by the agreement), in effect, is an agent of, or conduit for, another party to such agreement. Thus, although one party may not have de facto control over the business of the other party (as required by sec. 482), it may have unilateral control over the profit levels for both parties with respect to specific lines of business covered by a reinsurance agreement, which can be used to distort the income of the parties. The committee believes that whether a party is an agent of, or conduit for, another party must be determined in light of all the facts and circumstances. An example of a fact that would tend to establish that an agency relationship existed is control on the part of the reinsurer over the amount of policyholder dividends that are paid by the reinsured. Although Treasury's reallocation authority was expanded beyond that provided in TEFRA, the new authority is prospective only and does not apply to any contract issued before September 27, 1983, which is reinsured before such date under a reinsurance agreement entered into before such date. For purposes of determining when a contract is issued, any modifications of existing contracts to expand coverage of the contracts or renewals would be treated as new contracts.

Finally, the bill includes, as a permanent provision, the accounting rule adopted as a temporary provision in TEFRA for computing reserves for contracts that guarantee excess interest beyond the end of the taxable year. Under the bill, the provision is modified to reflect the new Federally prescribed reserve rules. Thus, any amount in the nature of interest that is credited under any contract for any period at a rate in excess of the prevailing State assumed interest rate for the contract for such period and is guaranteed beyond the end of the taxable year can only be taken into account in computing reserves as if it were guaranteed to the end of the taxable year. Under this rule, "amounts in the nature of interest" include both implicit and explicit guarantees for determining contractual benefits. Thus, "amounts in the nature of interest" refers to amounts credited to policyholder reserves as assumed interest or as interest paid on such items.

With respect to the special rules for amortization of premium and accrual of discount on bonds, and short taxable years for life insurance companies, the bill makes no change from present law.

h. Definition of company's share and policyholders' share (new sec. 812)

Present Law

Under present law, all items of investment yield (i.e., gross investment income, including tax-exempt interest and dividends received, less certain investment expenses) are allocated between the policyholders and the company. Amounts allocated to policyholders are not included in taxable investment income or gain from operations. Generally, this allocation is accomplished by means of a proration formula which, in general, compares amounts credited to policyholders to investment yield. The practical effect of the proration formula is to treat additions to reserves as funded in part out of tax-exempt income thus limiting the tax benefit a company can enjoy by the receipt of tax-exempt income.[21]

The proration formula is different depending upon whether taxable investment income or gain from operations is being computed. For purposes of computing taxable investment income, each item of investment yield is allocated between the policyholders and the company in the same proportion that the sum of the company's policy and other contract liabilities bears to its total investment yield. These policy and contract liabilities are (1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate (Menge formula), (2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earning's rate, and (3) interest paid, including interest paid on indebtedness to persons other than customers.

For purposes of computing gain from operations, each item of investment yield is allocated between the policyholders and the company in the same proportion as the required interest bears to the investment yield. Required interest is the amount of interest guaranteed to the policyholders using the interest rate assumed by the company for purposes of calculating the adjustments to its section 810(c) reserves, as well as excess interest on annuity contracts.

Explanation of Provision

The distinction between taxable investment income and gain from operations has been eliminated. However, the general concept that items of investment yield should be allocated between policyholders and the company has been retained. Under the bill, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under present law in computing gain or loss from operations. Thus, amounts credited to policyholders will no longer include interest paid on indebtedness if the interest is paid to a person who is not a customer. For example, interest paid on a loan that is incurred to purchase a subsidiary company or other asset will not be included in determining the policyholders' share of investment yield items. On the other hand, the bill expands the items to be taken into account for the policyholders' share by including all amounts that may be paid or credited to policyholders as customers, including policyholder dividends.

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[21] "Tax-exempt income" refers generally to tax-exempt interest and deductible intercorporate dividends.

Specifically, under the bill the policyholders' share of any item is 100 percent of the item reduced by the company's share of the item. The company's share is defined as the percentage obtained by dividing the company's share of net investment income by total net investment income. The company's share of net investment income is the excess of net investment income over the sum of (1) the deductible portion of policyholder dividends and (2) all amounts in the nature of interest paid or credited to policyholders as customers pursuant to insurance or annuity contracts (including all pension plan contracts). Thus, the company's share is the amount of net investment income that remains after paying or crediting amounts to policyholders.

Under the bill, net investment income is defined as the excess of gross investment income over investment expenses. Gross investment income is generally the same as under present law, and includes tax-exempt interest. However, gross investment income does not include dividends received from a subsidiary which are eligible for the 100 percent dividends received deduction (or which would have been eligible for the 100 percent dividends received deduction if the recipient were not a foreign corporation) except to the extent such dividends are paid, directly or indirectly, out of tax-exempt income. Investment expenses are defined as the sum of the direct investment expenses plus an allocable share of the general expenses. General expenses of the life insurance company must be allocated to gross investment income in the same proportion as gross investment income for the taxable year bears to the gross receipts for the taxable year. For purposes of this formula, general expenses are indirect expenses not directly allocable to investment income or underwriting income. For example, the cost of office space housing employees engaged in both underwriting and investment activities would be allocated under this provision while office space housing employees engaged in only investment activities would be treated as a direct investment expense.

Because reserve increases might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. Similarly, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends. 100 percent deductible dividends from affiliates are excluded from application of the proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be 100 percent deductible if received directly by the taxpayer.

i. Foreign tax credit (new sec. 818(f))

Present Law

Life insurance companies are generally subject to the same rules governing foreign income as other U.S. corporations. The United

States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid or accrued to a foreign country ("foreign tax credit").

A credit is available only for foreign taxes that are income taxes under U.S. concepts and certain taxes paid to a foreign government in lieu of an income tax otherwise imposed by that foreign government. Certain taxes on gross premiums of U.S. taxpayers engaged in the life insurance business in a foreign country have been held to be creditable "in lieu of" taxes (Rev. Rul. 74-311, 1974-2 C.B. 211; Rev. Rul. 72-84, 1972-1 C.B. 216). Income taxes paid by foreign subsidiaries of U.S. corporations are creditable when the U.S. corporation receives a dividend or a deemed dividend from the foreign subsidiary.

The foreign tax credit limitation

A fundamental premise of the foreign tax credit is that it should not offset U.S. tax on U.S. source income. Accordingly, the Code contains a limitation to ensure that the credit offsets the U.S. tax on only the taxpayer's foreign income. Under this limitation, the total pre-credit U.S. tax is multiplied by the ratio of foreign source taxable income to total worldwide taxable income to establish the amount of U.S. taxes that would be paid on the foreign income in the absence of a foreign tax credit. This amount is the upper limit on the foreign tax credit.

To calculate U.S. taxable income and foreign taxable income, which is necessary to compute the limitation, all deductions must be allocated against gross income, and apportioned against gross U.S. income or gross foreign income. Expenses that are properly allocated or apportioned to a class of U.S. (or foreign) source income reduce gross income in that category (sec. 861(b), 862(b), and 863; Reg. sec. 1.861-8). Expenses that cannot definitely be allocated to a class of gross income are generally deducted ratably from all classes of gross income.

The Internal Revenue Service has taken the position in [illegible] private letter ruling (applicable under pre-1982 law) that the numerator of the foreign tax credit limitation fraction (foreign source taxable income) is computed on a phase-by-phase basis. Thus, a company taxable on only its investment income (i.e., a phase-one company) would receive no foreign tax credit for premium taxes if all of its investment income were U.S. source income, even if the investment income arose from reserves held with respect to foreign business. Some taxpayers have taken the position that application of a phase-by-phase foreign tax credit limitation is improper under pre-1982 law.

Explanation of Provision

Elimination of the present law three-phase system presupposes that gross premium income and gross investment income contribute in similar ways to total income. The committee believes that certain deductions generally bear the same relationship to gross premium income that they bear to gross investment income. Similarly, these deductions generally bear the same relationship to gross U.S. source income that they bear to gross foreign source income. These deductions should, therefore, generally reduce U.S. source gross income and foreign source gross income ratably in calculating the foreign tax credit limitation. Similarly, reserve decreases should generally produce U.S. source gross income and foreign source gross income ratably.

Under its general rule, the bill provides that in calculating U.S. source income and foreign source income, three items will be treated under regulations as items which cannot definitely be allocated to an item or class of gross income. Thus, these items will be allocated ratably among all classes of gross income. These items are policyholder dividends (determined under new section 808(c)), reserve adjustments (under subsections (a) and (b) of new section 807), and death benefits and other amounts described in new section 805(a)(1).

The following example illustrates the application of the bill's general rule to a life insurance company that has $2,100 of gross income from all sources (including $100 of income from a net reserve decrease) and $1,800 of expenses (consisting of a death benefits deduction of $1,200 and a policyholder dividends deduction of $600):

	U.S. source	Foreign source	Worldwide
Gross income:			
Investment	$700	$300	$1,000
Premiums	600	400	1,000
Total	1,300	700	2,000
Percent	(65)	(35)	
Items subject to ratable allocation:			
Income from net reserve decrese	65	35	100
Death benefits deduction	(780)	(420)	(1,200)
Policyholder dividends deduction	(390)	(210)	(600)
Worldwide net income	195	105	300

Under the bill's general rule, these items will be allocated in this way regardless of the current residence of the decedents whose deaths caused the death benefit payments, the source of the premiums those decedents had paid the company in any year, the residence of the policyholders receiving or crediting dividends, or any other factor.

In some cases, the bill's general rule could be inequitable in its application to companies that can easily identify gross income to which these expenses relate. Therefore, taxpayers will be able to elect to treat the expenses that are the subject of the general rule of the bill as properly apportioned or allocated among items of gross income in the manner and to the extent prescribed in regulations. The election will apply for all taxable years of the taxpayer to which the bill applies. It must be made on or before September 15, 1984. Once made, it will be irrevocable, except with the consent of the Commissioner.

For example, a foreign country may require life insurance companies that sell policies there to maintain reserves there. In such a case, a taxpayer could show that some deductions for reserve increases, policyholder dividends, and claims should be treated as properly apportioned or allocated among items of gross income. In addition, a taxpayer could show that some such deductions should be treated as properly apportioned or allocated to some portion of the company's investment income attributable to the company's worldwide surplus. However, a taxpayer who makes such showings will not be able to show that those deductions are properly apportioned or allocated solely to an undue amount of foreign source investment income. For example, a company whose worldwide surplus is 15 percent of reserves and that makes the election will not be able to show that any of these deductions are properly apportioned or allocated solely to foreign source investment income (from any foreign country) attributable to surplus above 15 percent above reserves that the company must maintain in a foreign country.

The election will not apply to the special life insurance company and small life insurance company deductions. All companies will treat these deductions as items which cannot definitely be allocated to an item or class of gross income.

j. Foreign life insurance companies' minimum surplus (new sec. 813)

Present Law

Foreign corporations in general

Foreign corporations generally are subject to U.S. tax only on certain U.S. source income and on income that is effectively connected with a trade or business conducted in the United States. The United States generally imposes a flat 30-percent tax on the gross amount of U.S. source investment income (and certain other U.S. source income) paid to foreign persons when that income is not effectively connected with a U.S. trade or business. The tax on gross amounts of interest, dividends, and royalties may be reduced or eliminated under bilateral income tax treaties.

Taxation of foreign life insurance companies in general

A foreign corporation carrying on an insurance business within the United States, that would qualify as a life insurance company if it were a U.S. corporation, is taxable like a U.S. life insurance company on its income effectively connected with its conduct of any U.S. trade or business. The determination of whether a foreign corporation would qualify as a life insurance company considers only the income of the corporation that is effectively connected with the conduct of its business carried on in the United States.

Effectively connected income of a foreign corporation carrying on an insurance business within the United States includes all income (such as investment income attributable to required reserves) from foreign sources that is attributable to the U.S. business.[22] Such a foreign corporation is taxable at the 30 percent or lower treaty rate on its U.S. source investment income that is not effectively connected with a U.S. trade or business.

A foreign life insurance company that is engaged in a U.S. trade or business is taxable on U.S. source underwriting income but not on foreign source underwriting income (unless that foreign source underwriting income is effectively connected with a U.S. trade or business).

Minimum surplus requirement

A special rule may alter the U.S. tax on foreign life insurance companies doing business in the United States when they hold a relatively small surplus attributable to the U.S. business in the United States. This rule applies when the surplus of a foreign life insurance company held in the United States is less than a specified minimum. That minimum amount is the foreign company's total insurance liabilities on U.S. business multiplied by the ratio of the average surplus of domestic corporations to their total liabilities. The Secretary of the Treasury determines this ratio each year.

If the foreign insurance company's surplus held in the United States is less than this minimum amount, then certain deductions of the company decrease. The policy and other contract liability requirements, and the required interest for computing gain from operations, are reduced by the deficiency multiplied by the current earnings rate. An increase in tax caused by this adjustment of surplus may be offset by a reduction in the flat-rate tax on investment income not effectively connected with the U.S. business. The reason for reduction in the flat-rate tax is that part of that investment income, in effect, may be income subject to tax under the minimum surplus adjustment.

For the purpose of this minimum surplus requirement, Regulations provide for a separate computation of surplus with respect to segregated asset accounts of foreign life insurance companies. For such accounts, in general, the required surplus is 1 percent of liabilities (Treas. reg. sec. 1.819-2(b)(4)).

Explanation of Provision

The bill generally retains the Secretary's ratio adjustment, with modifications. A foreign company taxable as a life insurance company must compare its surplus held in the United States to a required surplus computed under the new statute. If the required surplus exceeds the actual surplus, the company must increase its income by the product of that excess and its current investment yield.[23]

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[22] Some Canadian insurance companies contended that the U.S.-Canada income tax treaty exempts from U.S. tax passive income they receive from Canadian sources, even when that passive income is effectively connected with and attributable to a U.S. business. The Court of Claims has rejected that contention (Great-West Life Assurance Co. v. United States, 82-1 USTC para. 9374 (1982)).

The bill requires the calculation of required surplus in a manner similar to the calculation of the "minimum figure" under present law. The Secretary of the Treasury is to calculate the percentage used in the taxpayer's calculation in a manner similar to the manner of present law. Taxpayers will calculate current investment yield by dividing net investment income on assets held in the United States by the mean of assets held in the United States. For this purpose, only, the taxpayer is to use amounts required to be set forth on the NAIC annual statement.

The bill also provides definitions of surplus held in the United States and total insurance liabilities. Surplus held in the United States is the excess of assets held in the United States over the total insurance liabilities on U.S. business. For the purpose of valuing assets in the determination of surplus, the committee intends that the Secretary promulgate regulations that indicate that taxpayers are not to value assets under the method used in the NAIC statement, but are to use a method similar to the method prescribed under present law. Total insurance liabilities mean the sum of total reserves (as defined in new sec. 816(c)) plus, to the extent not included in total reserves, the items referred to in paragraphs (3), (4), (5), and (6) of new section 807(c). The committee intends that the Secretary adopt regulations governing required surplus attributable to segregated asset accounts similar to the regulations in effect under current law.

As under present law, an increase in tax caused by this adjustment of surplus may be offset by a reduction in the flat-rate tax on investment income not effectively connected with the U.S. business.

The bill provides a new rule for foreign mutual life insurance companies that reflects the equity base concept of the new statute. Each such company that is taxable as a life insurance company in the United States is to increase its equity base by the excess (if any) of its required surplus over its actual surplus.

k. Contiguous country branches of U.S. life insurance companies (new sec. 814)

Present Law

U.S. corporations are taxable on worldwide income, including foreign income (although the foreign tax credit may offset U.S. tax on foreign income). In general, foreign corporations (even those wholly owned by U.S. persons) are not subject to U.S. tax on foreign income. U.S. shareholders of a foreign corporation generally are exempt from U.S. tax on the earnings of the foreign corporation until it pays them a dividend (unless it engages in tax-haven or tax avoidance activity). Foreign branch operations of U.S. taxpayers generally are subject to tax currently.

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[23] Some have suggested that this imputation of income (rather than a reduction of a deduction, as in present law) may exceed the taxing power granted under the Sixteenth Amendment. Were this or any other provision of this title of the bill found to be unconstitutional, the committee intends sec. 7852(a) to operate to preserve the remainder of the bill's provisions.

Branches of mutual companies generally derive their income from the issuance of policies on local risks and from investment income from reserves on local risks. Under the principle of mutuality, this income inures solely to the benefit of local policyholders. Thus, a foreign branch of a mutual life insurance company is similar to a foreign corporation owned by non-U.S. persons. Congress, therefore, provided that a U.S. mutual life insurance company may generally elect to exempt the income of its branches that operate in Canada or Mexico (sec. 819A)[24] so long as the foreign branch does not repatriate its income to the United States. Repatriation of contiguous country branch income results in an increase in life insurance company taxable income. In this respect, the treatment of contiguous country branches corresponds generally to the treatment of foreign subsidiaries of U.S. parent companies.

In general, a transfer of property by a U.S. person to a foreign corporation can qualify for nonrecognition treatment only if the exchange does not have as one of its principal purposes the avoidance of U.S. tax (sec. 367). A special rule applies (1) to elections by U.S. mutual life companies to use the special contiguous country branch rule and (2) to certain incorporations by U.S. stock life companies of contiguous country subsidiaries. In general, in each case, there is a deemed sale of the invested assets and tangible property subject to the election or transferred in the incorporation. The gain that the company must recognize is the excess of the fair market value of those invested assets and that tangible property over their aggregate adjusted basis. The company does not recognize gain attributable to goodwill, since it is an intangible asset.

Explanation of Provision

The bill retains the contiguous country branch rule of present law, with technical modifications. Thus, repatriation of contiguous country branch income will result in an increase in income. As under present law, payments, transfers, reimbursements, credits, or allowances which are made from a separate contiguous country branch account to one or more accounts of the domestic company as reimbursements for costs (e.g., home office services) incurred for or with respect to the insurance (including reinsurance) of risks accounted for in the separate branch account are taken into account by the domestic company in the same manner as if the payment, transfer, reimbursement, credit, or allowance were received from a separate person. For this purpose the rules in the Internal Revenue Code (sec. 482) dealing with reimbursement of costs between related parties continue to apply and the domestic company must establish procedures for billing the branch at arm's length. As under present law, reimbursements under this provision are not treated as repatriation of income.

If amounts are directly or indirectly transferred or credited from a contiguous country branch account to one or more other accounts of the domestic company they are to be added to the income of the domestic company except to the extent the transfers are reimbursements for home office services. The amount added to income cannot exceed the amount by which the aggregate decrease in the tentative LICTI for the taxable year and for all prior taxable years resulting solely from the application of these exclusion provisions with respect to the contiguous country branch exceeds the amount of additions to the tentative LICTI with respect to that branch which were treated as a repatriation of income for all prior taxable years. For this purpose, in the case of a prior taxable year beginning before January 1, 1983, "tentative LICTI" means life insurance company taxable income computed under the law in effect during the earlier taxable year.

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[24] For the legislative history of these life insurance company provisions, see H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 248-252, and S. Rep. No. 94-938, 94th Cong., 2d Sess. 271-275.

Section 113 of the bill provides that an election under section 819A of current law will be treated as an election under new section 814, and that references to new section 814 will be treated as references to the corresponding provision of section 819A of current law.

l. Rules relating to capital gains and losses (new sec. 818)

Present Law

With respect to property used in a trade or business and held for more than 12 months, present law provides, in general, that if the gains from the sale or exchange of such property exceed such losses, then each gain and loss is treated as though it was from the sale or exchange of a long-term capital asset. If the losses exceed the gains, then each gain or loss is considered as not being from the sale or exchange of a capital asset, with the result that ordinary gain or loss is realized.

In the case of life insurance companies, a special rule applies which modifies the general rule by limiting the term "property used in the trade or business" to include only property used in carrying on an insurance business. Further, for purposes of section 1221(2) (excluding certain property from the term "capital assets"), the reference to property used in trade or business is treated as including only property used in carrying on an insurance business.

In both cases, the term "property used in carrying on an insurance business" means only those assets used in the operation of the insurance trade or business.

Under present law, the amount of gain that is recognized on the sale or other disposition of certain property acquired before December 31, 1958 is limited. In the case of property acquired after December 31, 1958, having a substituted basis (within the meaning of sec. 1016(b)), the limitation on the gain recognized shall apply if the property or properties were held only by life insurance companies during the relevant periods. The term "property" does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221 relating to stock in trade or inventory-type property.

Explanation of Provision

The bill continues the present-law treatment relating to capital gains and losses and gains and losses on property used in the trade or business for life insurance companies. These rules are found in new sections 818(b), (c), and (d).

Under the present-law provisions, there are regulations for assumption reinsurance transactions which are generally treated as a sale of a block of business. The bill continues the current distinction between indemnity and assumption reinsurance arrangements.

m. Technical and conforming amendments (sec. 211(b) of the bill)

Section 211(b) of the bill contains 27 technical changes to the provisions of the Internal Revenue Code of 1954 outside of Part I of subchapter L. These amendments conform the existing provisions of the 1954 Code to the new single phase tax system adopted for life insurance companies under the bill.

n. Effective date and transitional rules (secs. 215, 216, and 217 of the bill)

Effective Date

Generally, the life insurance company taxation provisions apply to taxable years beginning after December 31, 1983.

Transitional Rules

Reserves computed on a new basis

As of the beginning of the first taxable year after December 31, 1983, the reserve for any contract shall be recomputed as if the amendments made in this bill had applied to such contract when it was issued.

Any change in accounting (e.g., in computing the policyholder dividends deduction) or any change in the method of computing reserves which is required by the amendments made in this bill will not be treated as a change in the method of accounting or in the method of computing reserves, and will not give rise to income or loss. This "fresh start" provision will apply solely to changes made between any company's first taxable year beginning after December 31, 1983, and the preceding taxable year.

This "fresh start" rule is not applicable to any recomputation of reserves transferred pursuant to a reinsurance agreement entered into, modified or terminated after September 27, 1983, and before January 1, 1984. The bill also provides that if expenses have been transferred between insurance companies pursuant to a reinsurance agreement that is entered into, modified, or terminated after September 27, 1983 (and before January 1, 1984), any income attributable to those expenses and taken into account in a later year cannot be taken into account for purposes of determining the amount of the special life insurance company deduction and the small life insurance company deduction. Under this provision, a company is required to take into account any decrease in reserves caused by the recomputation of tax reserves, and cannot take into account expenses, to the extent the reserves or expenses were transferred between the parties pursuant to a reinsurance agreement the entering into, modification or termination of which was within the prohibited period of time. However, if the entering into, modification or termination of the agreement occurred during such time because of a binding agreement between the parties or written notice on an earlier date, the date of the earlier agreement controls whether there is a denial of the fresh start provisions of the bill.

Also, the "fresh start" rule does not apply to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984. For these purposes, the phrase "any reserve strengthening" is intended to refer to the computation of reserves on contracts issued in 1983 at an interest rate that is lower than the rate normally assumed in computing reserves for similar contracts, or to the strengthening of reserves for tax purposes, generally, on existing business. An election to revalue reserves under present-law section 818(c) that is made on a return filed after September 27, 1983, and increases the reserves for tax purposes, will be considered general reserve strengthening for tax purposes under this provision to the extent of the benefit received by the taxpayer from the election.

Under the bill, any income arising from the nonapplication of the "fresh start" rule will be taken into account over 10 years and will be added to income ratably in each year after determining the amount of the special life insurance company deduction and the small life insurance company deduction.

If a life insurance company changed its method of computing reserves, which resulted in a decrease in reserves in any taxable year beginning before 1984, the resulting income will not be taken into account in any taxable year beginning after 1983. Thus, a company that changed its reserve method in a manner that reduced the reserves before adoption of the new Federally prescribed reserve rules will not be treated differently from a company whose reserves for tax purposes are reduced by the bill. However, any increase in reserves resulting from a change in a tax year beginning before 1984 shall be taken into account after 1983 to the extent that the amount of the increase that would have been taken into account (under present law) after 1983 exceeds the amount of any fresh start adjustment attributable to contracts for which there was such an increase in reserves. Likewise, no premium will be included in income to the extent such premium is directly related to an increase in a reserve for which a deduction is disallowed under this provision of the bill.

Installment contracts

If, prior to January 1, 1984, an election is made to treat income from an installment obligation as investment income, any income from such obligation shall be treated as attributable to a noninsurance business. Noninsurance business is defined as any trade or business which is not an insurance business; however, any noninsurance business that traditionally has been carried on by life insurance companies for investment purposes shall be treated as an insurance business.

Determination of tentative LICTI in cases of acquisitions in 1980, 1981, 1982 and 1983.

In certain specific cases that involve the acquisition of 1 or more insurance companies, a transitional rule is provided which permits increases in tentative LICTI for taxable years beginning after December 31, 1983, and before January 1, 1986. In order to qualify, a corporation had to acquire the assets of one or more insurance companies after 1979 and before April 1, 1983. In addition, the bases of the acquired assets in the hands of the acquiring corporation had to have been determined under sec. 334(b)(2) (relating to the basis of property received in complete liquidation of a subsidiary) or the corporation had to have made an election under sec. 338 (relating to the treatment of stock purchases as asset acquisitions). If these tests are met, then the tentative LICTI of the corporation holding the assets for taxable years 1984 and 1985 shall be increased by the deduction allowable for the amortization of the cost of insurance contracts acquired in the acquisition and for any portion of any operations loss deduction attributable to such amortization.

The effect of the increase in tentative LICTI is to increase the base for the 60 percent (of the first $3 million) small life insurance company deduction and the 25 percent special life insurance company deduction.

Special allocation rule for reinsurance agreements

Any contract that was issued before September 27, 1983, which is reinsured before that date under a reinsurance agreement entered into before September 27, 1983, will not be subject to the allocation and recharacterization authority granted the Secretary of the Treasury in section 811(d) of this bill.

Treatment of a stock-mutual company

Any company that has been operating for a ten-year period ending on December 31, 1983, as a mutual life insurance company with shareholders, as authorized by the law of the State in which it is domiciled, shall be treated as a stock life insurance company, except that such company shall be treated as a mutual life insurance company with respect to the mutual portion of its equity base. In any calendar year, the mutual portion of items of gain from operations, equity base, dividends to policyholders, assets, reserves, and any other items shall be determined as prescribed for reporting in the annual statement.

3. Taxation of Life Insurance Products

a. Definition of a life insurance contract (new sec. 7702)

Present Law

Generally, there is no statutory definition of life insurance under present law. A life insurance contract is defined generally in section 1035 (relating to tax-free exchanges) as a contract with a life insurance company which depends in part on the life expectancy of the insured and which is not ordinarily payable in full during the life of the insured.

Income earned on the cash surrender value of a contract is not taxed currently to the policyholder, but it is taxed upon termination of the contract prior to death to the extent that the cash surrender value exceeds the policyholder's investment in the contract, i.e., the sum of all premiums paid on the contract. Gross income does not include amounts received by a beneficiary under a life insurance contract, if the amounts are paid because of the death of the insured.

In TEFRA, Congress enacted temporary guidelines for determining whether flexible premium life insurance contracts (e.g., universal life or adjustable life) qualified as life insurance contracts for purposes of the exclusion of death benefits from income. Violation of the guidelines at any time during the contract causes the contract to be treated as providing a combination of term life insurance and an annuity or a deposit fund (depending on the terms of the contract). In the event of the death of the insured, only the term life insurance component is excluded from gross income.

1982 and 1983 temporary guidelines

Under the temporary guidelines which apply to 1982 and 1983, death proceeds from flexible premium life insurance contracts are treated as life insurance if either of two tests are met.

Alternative 1

Under the first of the two alternative tests, a contract qualifies if:

(a) The sum of the premiums paid for the benefits at any time does not exceed the net single premium (based on interest rates at 6 percent) or the sum of the net level premiums (based on interest rates at 4 percent), assuming the policy matures no earlier than in 20 years or at age 95, (if earlier); and

(b) the death benefit is at least 140 percent of cash value at age 40, phasing down one percentage point each year to 105 percent.

Alternative 2

Under the second of the two alternative tests, a contract qualifies if the cash surrender value does not exceed the net single premium (based on interest rates at 4 percent and the most recent mortality table) for the amount payable at death, assuming the policy matures no earlier than age 95.

Explanation of Provision

The bill adopts a definition of a life insurance contract for purposes of the Internal Revenue Code. This provision extends to all life insurance contracts rules that are similar to those contained in the temporary provisions of TEFRA. Since the committee was concerned with the proliferation of investment-oriented life insurance products, the definition has been narrowed in some respects.

Definition of life insurance

A life insurance contract is defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. Whichever test is chosen, that test must be met for the entire life of the contract in order for the contract to be treated as life insurance for tax purposes.

The term "life insurance contract" does not include that portion of any contract that is treated under State law as providing any annuity benefits other than as a settlement option. Thus, although a life insurance contract may provide by rider for annuity benefits, the annuity portion of the contract is not part of the life insurance contract for tax purposes and such annuity benefits may not be reflected in computing the guideline premiums. Thus, an insurance arrangement written as a combination of term life insurance with an annuity contract, or with a premium deposit fund, is not a life insurance contract for purposes of the guidelines because all of the elements of the contract are not treated under State law as providing a single integrated death benefit. As a result, only the term portion of any such contract can meet the tests and be treated as life insurance proceeds upon the insured's death. However, any life insurance contract that is treated under State law as a single, integrated life insurance contract and that satisfies these guidelines will be treated for Federal tax purposes as a single contract of life insurance and not as a contract that provides separate life insurance and annuity benefits.

In the case of variable life insurance contracts (as defined in sec. 817), the determination as to whether the contract meets the cash value accumulation test, or the guideline premium requirements, and falls within the cash value corridor shall be made whenever the amount of the death benefits under the contract change, but not less frequently than once during each 12-month period. Further, if a contract is checked to see if it satisfies the requirements once a year, the determination must be made at the same time each year.

Cash value accumulation test

The first alternative test under which a contract may qualify as a life insurance contract is the cash value accumulation test. This test is intended to allow traditional whole life policies, with cash values that accumulate based on reasonable interest rates, to continue to qualify as life insurance contracts. Certain contracts that have been traditionally sold by life insurance companies, such as endowment contracts, will not continue to be classified as life insurance contracts because of their innate investment orientation.

Under this test, the cash surrender value of the contract may not at any time exceed the net single premium which would have to be paid at such time in order to fund the future benefits under the contract assuming the contract matures no earlier than age 95 for the insured. Thus, this test allows a recomputation of the limitation (the net single premium) at any point in time during the contract period based on the future benefits guaranteed under the contract at that time. The term future benefits under the bill means death benefits and endowment benefits. The death benefit is the amount that is payable in the event of the death of the insured, without regard to any qualified additional benefits. Cash surrender value is defined in the bill as the cash value of any contract (i.e., any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend. For these purposes, termination dividends will be considered reasonable based on what has been the historical practice of the industry in paying such dividends. Historically, termination dividends have been modest in amount. For example, the committee understands that New York State prescribes a maximum termination dividend of $35 per $1000 of face amount of the policy. Just as termination dividends are not reflected in the cash surrender value, any policyholder dividends left on deposit with the company to accumulate interest is not part of the cash surrender value of a contract; interest income on such dividend accumulations is currently taxable to the policyholder because the amounts are not held pursuant to an insurance or annuity contract. Likewise, amounts that are returned to a policyholder of a credit life insurance policy because the policy has been terminated upon full payment of the debt will not be considered part of any cash surrender value because, generally, such amount is not subject to borrowing under the policy.

Whether a contract meets this test of a life insurance contract will be determined on the basis of the terms of the contract. In making the determination that a life insurance contract meets the cash value accumulation test, the net single premium for any time will be computed using a rate of interest that is the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. To be consistent with the definitional test reference to the cash surrender value, the "rate or rates guaranteed on the issuance of the contract" means the interest rate or rates reflected in the contract's nonforfeiture values. With respect to variable contracts that do not have a guaranteed rate, then the 4-percent rate shall apply. The mortality charges taken into account in computing the net single premium will be those specified in the contract or, if none are specified in the contract, the mortality charges used in determining the statutory reserves for the contract.

The amount of any qualified additional benefits will not be taken into account in determining the net single premium. However, the charge stated in the contract for the qualified additional benefit will be treated as a future benefit, thereby increasing the cash value limitation by the discounted value of such charge. For life insurance contracts, qualified additional benefits are guaranteed insurability, accidental death or disability, family term coverage, disability waiver, and any other benefits prescribed under regulations. In the case of any other additional benefit which is not a qualified additional benefit and which is not prefunded, neither the benefit nor the charge for such benefit will be taken into account. For example, if a contract provides for business term insurance as an additional benefit, neither the term insurance nor the charge for the insurance will be considered a future benefit.

Guideline premium and cash value corridor test requirements

The second alternative test under which a contract may qualify as a life insurance contract has two requirements; the guideline premium limitation and the cash value corridor. The guideline premium portion of the test distinguishes between contracts under which the policyholder makes traditional levels of investment through premiums and those which involve greater investments by the policyholder. The cash value corridor disqualifies contracts which allow excessive amounts of cash value to build up (i.e., premiums, plus income on which tax has been deferred) relative to the life insurance risk. In combination, these requirements are intended to limit the definition of life insurance to contracts which require only relatively modest investment and permit relatively modest investment returns.

The specifics of these requirements are described below.

Guideline premium limitation.—A life insurance contract will meet the guideline premium limitation if the sum of the premiums paid under the contract does not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums to such date. The guideline single premium for any contract is the premium at issue required to fund future benefits under the contract. The computation of the guideline single premium must take into account (1) the mortality charges specified in the contract, or used in determining the statutory reserves for the contract if none is specified in the contract, (2) any other charges specified in the contract (either for expenses or for supplemental benefits), and (3) interest at the greater of a 6-percent annual effective rate or the minimum rate or rates guaranteed on the issuance of the contract. The guideline level premium is the level annual amount, payable over a period that does not end before the insured attains age 95, which is necessary to fund future benefits under the contract.[25] The computation is made on the same basis as that for

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[25] To the extent the guideline level premium includes a charge for an additional benefit that is scheduled to cease at a certain age (i.e., there are discrete payment periods for separate policy

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the guideline single premium, except that the statutory interest rate is 4 percent instead of 6 percent.

A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation will not result in the contract failing the test if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year, but only if the contract would terminate without cash value but for such payment. Also, if it is established to the satisfaction of the Secretary that the requirement was not met due to reasonable error and reasonable steps are being taken to remedy the error, the Secretary may waive the first requirement. Premium amounts returned to a policyholder, with interest, within 60 days after the end of a contract year in order to comply with the guideline premium requirement are treated as a reduction of the premiums paid during the year. The interest paid on such return premiums is includible in gross income. This "hold harmless" provision in the event of a timely correction is comparable to similar provisions elsewhere in the Code.

Cash value corridor.—A life insurance contract will fall within the cash value corridor if the death benefit under the contract at any time is equal to at least the applicable percentage of the cash surrender value. Applicable percentages are set forth in a statutory table. Under the table, an insured person, who is 55 years of age at the beginning of a contract year and has a life insurance contract with $10,000 in cash surrender value, must have a death benefit at that time of at least $15,000 (150 percent of $10,000).

As the table shows, the applicable percentage to determine the minimum death benefit starts at 250 percent of the cash surrender value for an insured person up to 40 years of age, and the percentage decreases to 100 percent when the insured person reaches age 95. Starting at age 40, there are 9 age brackets with 5-year intervals (except for one 15-year interval) to which a specific applicable percentage range has been assigned. The applicable percentage will decrease by the same amount for each year in that age bracket. For example, for the 55 to 60 age bracket, the applicable percentage falls from 150 to 130 percent, or 4 percentage points for each annual increase in age. At 57, the applicable percentage will be 142.

The statutory table of applicable percentages follows.

In the case of an insured with an attained age as of the beginning of the contract year of:		The applicable percentages shall decrease by a ratable portion for each full year:	
More than—	But not more than	From—	To—
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150

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benefits), the charges for such benefit should be reflected in a level manner over the period such charges are being incurred. This prevents post-funding of the qualified additional benefit.

In the case of an insured with an attained age as of the beginning of the contract year of:		The applicable percentages shall decrease by a ratable portion for each full year:	
More than—	But not more than	From—	To—
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

For purposes of applying the cash value corridor and the guideline premium limitation (as well as the computational rules described below), the attained age of the insured means the insured's age determined by reference to contract anniversaries (rather than the individual's actual birthdays), so long as the age assumed under the contract is within 12 months of the actual age.

Computation of benefits

The bill provides three general rules or assumptions to be applied in computing the limitations set forth in the definitional tests. These rules only restrict the actual provisions and benefits that can be offered in a life insurance contract to the extent that they restrict the allowable cash surrender value (under both tests) or the allowable funding pattern (under the guideline premium limitation).

First, in computing the benefits under any contract, the death benefit shall be deemed not to increase at any time during the life of the contract (qualified additional benefits will be treated in the same way). Thus, a contract cannot assume a death benefit that decreases in earlier years and increases in later years in order to avoid the guideline premium limitation. Second, the maturity date shall be deemed to be no earlier than the day on which the insured attains age 95. For these purposes, the term maturity date generally means the termination date set forth in the contract or the end of the mortality table. This rule generally prevents contracts endowing before age 95 from qualifying as life insurance. The amount of any endowment benefit, or the sum of any endowment benefits, shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract. For these purposes, the term endowment benefits includes the cash surrender value at the maturity date.

Notwithstanding the first computational rule, under certain circumstances, an increase in the death benefit (which is provided in the contract) may be taken into account for purposes of meeting the two definitional tests provided by the bill. Specifically, in computing the guideline level premium (only) for a contract, an increasing death benefit may be recognized to the extent necessary to prevent a decrease in the excess of the death benefit over the cash surrender value. Under a similar modification of the cash value accumulation test, the cash surrender value cannot exceed at any time the net level reserve. For this purpose, the net level reserve would be determined as though level annual premiums were paid for the contract until the insured attains age 95. These modifications to the computational rules would allow the sale of contracts where the death benefit is defined as the cash surrender value plus a fixed amount of pure life insurance protection.

Adjustments

The bill provides that proper adjustments be made for any change in the future benefits or any qualified additional benefit (or in any other terms) under the contract, which was not reflected in any previous determination made under the definitional section. Changes in the future benefits or terms of a contract can occur at the behest of the company or the policyholder, or by the passage of time. In the event of an increase in current or future benefits the limitations under the alternative tests must be computed treating the date of change, in effect, as a new date of issue for determining whether the changed contract continues to qualify as life insurance under the definition prescribed in the bill. For example, under the cash value accumulation test, if a future benefit is increased because of a scheduled change in death benefit or because of the purchase of a paid-up addition (or its equivalent), such a change will require an adjustment and new computation of the net single premium definitional limitation. Likewise, under the guideline premium limitation, an adjustment will be required under similar circumstances, but no adjustment shall be made if the change occurs automatically due, for example, to the crediting of excess interest. Under the bill, the Secretary of the Treasury has authority to prescribe regulations governing how such adjustments and computations should be made. Further, there is a special provision that any change in the terms of a contract that reduces the future benefits under the contract shall be treated as an exchange of contracts (under sec. 1035), and so may give rise to a distribution taxable to the policyholder. This provision is specifically intended to apply to situations in which a policyholder changes from a future benefits pattern taken into account under the computational provision for policies with increases in death benefits to a future benefit of a level amount (even if at the time of change the amount of death benefit is not reduced). If the adjustment provision results in a distribution to the policyholder in order to meet the adjusted guidelines, the distribution will be taxable to the policyholder as ordinary income to the extent there is income in the contract. However, the provisions that certain changes in future benefits be treated as exchanges is not intended to alter the application of the transition rules for life insurance contracts (explained below).

Contracts not meeting the life insurance definition

If a life insurance contract does not meet either of the alternative tests under the definition of a life insurance contract, the income on the contract for any taxable year of the policyholder will be treated as ordinary income received or accrued by the policyholder during that year. For this purpose, the income on the contract is the amount by which the sum of the increase in the net surrender value of the contract during the taxable year and the cost of life insurance protection provided during the taxable year under the contract exceed the amount of premiums paid less any policyholder dividends paid under the contract during the taxable year. The term premiums paid means the amounts paid as premiums under a contract less amounts to which the rules for allocation between income and investment under annuity and other contracts in section 72(e) apply. Because the income on the contract is treated as received by the policyholder, the income would be a distribution subject to the recordkeeping, reporting, and withholding rules under present law relating to commercial annuities (including life insurance). It is hoped this will provide the policyholder with adequate notice that disqualification has occurred, thus giving some protection against underpayment of estimated taxes.

The income on the contract for all prior taxable years will be treated as received or accrued during the taxable year in which a life insurance contract ceases to meet the definition of a life insurance contract. The cost of life insurance protection provided under any contract will be the lesser of the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums, computed using 5-year age brackets, as prescribed by the Secretary by regulations, or the mortality charge stated in the contract.

The excess of the amount of death benefit paid over the net surrender value of the contract will be treated as paid under a life insurance contract for purposes of the exclusion from income with respect to the beneficiary.

Endowment contracts which meet the requirements of the definition of a life insurance contract will receive the same treatment as a life insurance contract. If a life insurance contract fails to meet the tests in the definition, it will nonetheless be treated as an insurance contract for tax purposes. This insures that the premiums and income credited to failing policies will continue to be taken into account by the insurance company in computing its taxable income. In addition, it insures that a company that issues failing policies continue to qualify as an insurance company.

Effective Date

General effective date

Generally, the new definition of life insurance applies to contracts issued after December 31, 1983. Contracts issued in exchange for existing contracts after December 31, 1983 are to be considered new contracts issued after that date.

Transition rules

Contracts issued during 1984.—Any insurance contract that is issued during 1984 pursuant to an existing plan of insurance will be treated as meeting the definitional requirements of a life insurance contract: (1) if the contract (whether or not a flexible premium contract) meets the requirements of the temporary provisions enacted in TEFRA; (2) if a contract (that is not a flexible premium life insurance contract as defined under sec. 101(f)) meets the requirements set forth in this bill by substituting 3 percent for 4 percent as the minimum interest rate to be used in the cash value accumulation test and the maturity date is deemed to be the latest permitted under the contract (but not less than 20 years after the date of issue or, if earlier, age 95); or (3) if the contract meets certain definitional requirements as an irreplaceable life insurance contract.[26]

Contracts issued pursuant to existing plans of insurance.—Under another transition rule, certain qualified contracts under existing plans of insurance will qualify as life insurance contracts under the cash value accumulation test, discussed above, if the contracts would meet the test using 3-percent, instead of 4-percent, as the minimum interest rate. A "qualified contract" will mean any contract that requires at least 20 nondecreasing annual premium payments and is issued pursuant to an existing plan of insurance. An existing plan of insurance is any plan of insurance or policy blank that has been filed by the issuing company in one or more States before September 28, 1983. It is intended that the 20-pay requirement will not be violated by a plan of insurance that provides for the purchase of insurance by means of paid-up additions, if the additional amounts are modest and reasonable compared with the basic benefit under the contract.

b. Treatment of certain annuity contracts (sec. 72)

Present Law

Cash withdrawals prior to the annuity starting date are includible in gross income to the extent that the cash value of the contract (determined immediately before the amount is received and without regard to any surrender charge) exceeds the investment in the contract. A penalty tax of 5 percent is imposed on the amount of any such distribution that is includible in income, to the extent that the amount is allocable to an investment made within 10 years of the distribution. The penalty is not imposed if the distribution is made after the contractholder attains age 59½, when the contractholder becomes disabled, upon the death of the contractholder or as a payment under an annuity for life or at least 5 years. No income is recognized to the recipient of an annuity on the death of the contractholder. However, since the recipient has the same investment in the contract as the deceased contractholder, the recipient is subject to income tax on the income accumulated in the contract prior to death when it is distributed from the contract.

Explanation of Provision

Penalty on premature distributions

However, the bill generally retains the present-law provisions for annuity contracts. The 5-percent penalty on premature distributions will apply to any amount distributed to the taxpayer before the age of 59½ without regard to whether the distribution is allocable to an investment made within 10 years. This is consistent with a general objective of the bill to encourage retirement savings as opposed to short-term savings.

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[26] That is, under such contract, (i) the premiums (including any policy fees) will be adjusted from time to time to reflect the level amount necessary (but not less than zero) at the time of such adjustment to provide a level death benefit assuming interest crediting and an annual effective interest rate of not less than 3 percent, or (ii) at the option of the insured, in lieu of an adjustment under clause (i), there will be a comparable adjustment in the amount of the death benefit.

Distribution in event of annuity holder's death

In the event that the owner of any annuity contract dies before the annuity starting date, an amount equal to the cash surrender value of such contract shall be treated as paid to the contractholder immediately before death. Thus, the income in the contract will be subject to income tax in the decedents return for the year of death. To prevent a second taxation when amounts are actually distributed to the new owner, the amount deemed to be distributed under the contract, that is, the amount includible in gross income of the decedent, is treated as a premium paid for the contract. The 5-percent penalty tax on a premature distribution from an annuity shall not apply to any amount includible in gross income because of the deemed distribution in the event of the contractholder's death.

This amendment will not apply to amounts received under contracts issued under qualified plans or IRAs. For this purpose, qualified plans are plans that have received employer contributions that were deductible from gross income when made.

Effective Date

These amendments to the annuity rules shall apply to contracts issued after the day which is six months after the date of enactment.

c. Policyholder loans (new sec. 264(d))

Present Law

Generally, taxpayers are allowed to deduct interest paid or accrued on indebtedness during the taxable year. However, no deduction is allowed for (1) any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract; (2) any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract that is treated as a single premium contract) pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in cash value of such contract.

There are a number of exceptions to the rule disallowing a deduction for interest on indebtedness incurred or continued with respect to a contract other than a single premium contract or a contract that is treated as a single premium contract. Under the exceptions, a deduction is allowed if (1) no part of four of the first seven annual premiums due under the contract is paid by means of indebtedness; (2) the total of the amounts paid or accrued during the taxable year does not exceed $100; (3) the amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or an unforeseen increase in financial obligations; or (4) the indebtedness was incurred in connection with the taxpayer's trade or business. If the requirements of any one of these four exceptions are satisfied, a taxpayer can deduct the full amount of interest otherwise deductible on an unlimited amount of indebtedness.

Explanation of Provisions

The bill amends present law by adding a limitation on the amount of interest that is deductible. Thus, amounts that are not deductible under present law are not deductible under the bill.

The applicable limits

Under the bill, individual policyholders, and businesses owning policies insuring the lives of individuals are allowed to deduct, for any taxable year, an amount of life insurance interest equal to the applicable limit for such taxable year. Life insurance interest is defined as interest paid or accrued in connection with a life insurance loan. A life insurance loan is any indebtedness if (1) the interest paid or accrued with respect to such indebtedness would, but for this provision, be deductible (i.e., the transaction is not a disguised distribution of the cash value of the policy); and (2) the indebtedness is (a) incurred under, or secured by, a life insurance, endowment, or annuity contract, or (b) incurred or continued to purchase or carry a life insurance, endowment or annuity contract. This definition of a life insurance loan is provided, in part, to clarify that interest paid on a loan from a third party secured by the cash value of a life insurance contract is deductible only if it is deductible under section 264 and under the limitations contained in this provision.

The applicable limit for an individual policyholder for any taxable year is an amount equal to the product $250,000 ($500,000 in the case of a joint return) multiplied by the deficiency rate prescribed under section 6621 in effect as of the first day of the taxable year. The applicable limit for a business is the product of $500,000 multiplied by the section 6621 deficiency rate for each qualified life. Although the committee recognizes that the use of the deficiency rate will result in changing limits for various years, it believes such a rule is necessary in order to administer this provision and may be accommodated by variable rate loans under life insurance contracts.

Business taxpayers

For purposes of this provision, the $500,000 business limitation is for corporations, partnerships, proprietorships, or other entities engaged in a trade or business. An unincorporated trade or business operated by an individual constitutes a proprietorship. Businesses may deduct interest subject to an aggregate limitation based on the number of qualified lives.

Qualified lives are defined in the bill by reference to the amount of coverage provided as a percentage of the maximum amount provided under a policy owned by the business. Under the bill, a "qualified life" is an individual insured under a life insurance policy owned by a corporation, partnership, proprietorship or other entity engaged in a trade or business if (1) at some time during the taxable year, the life of the individual is insured under a whole life policy owned by the business, (2) there has been outstanding a life insurance loan with respect to such policy during the taxable year, and (3) the face amount of such policy is at least as 10 percent of the highest face amount of a whole life policy owned by the business, which insures the life of any other individual, and had outstanding a life insurance loan during the taxable year. Thus, if a corporation owns policies insuring the lives of three individuals, and the face amount of two of the policies is $1,000,000 and the face amount of the other is $50,000, the individual with respect to whom the $50,000 policy is held is not a qualified life. Thus, the corporation will be subject to an interest limitation of $2,000,000 times the appropriate deficiency rate.

Carryover of unused limitation

Any excess limitation is carried over and added to the limitation for the succeeding taxable year. Thus, if for any taxable year a taxpayer fails to pay or incur and deduct an amount of interest equal to the maximum deductible amount (the applicable limit), the excess of the maximum amount over the amount that is deducted is added to and increases the maximum deductible amount for the succeeding taxable year. For example, assume that in a particular taxable year an individual not engaged in a trade or business borrows $10,000 at 8 percent and pays and deducts $800 of interest. If the deficiency rate under section 6621 for that year is 11 percent, the individual's unused interest limitation would be $26,700 (i.e., $250,000 X .11 −$800). If the deficiency rate is the same the next year, the individual's limitation for the next taxable year would be $54,200, ($26,700 + $250,000 X .11) The unused amounts carryover indefinitely. No carryover arises, however, with respect to a year in which there are no outstanding life insurance loans to the taxpayer or if the loans are on policies not covered by the new provisions adopted by the bill.

Effective Date

The provisions of the bill relating to the deduction of life insurance interest apply with respect to interest paid or accrued in taxable years ending after September 27, 1983. The provision does not apply, however, to any indebtedness incurred under, secured by, or incurred or continued to purchase or carry a life insurance, endowment or annuity contract if such contract was issued before September 28, 1983, or was issued on or after such date pursuant to a binding contract entered into before such date. The limitation on a life insurance loan shall not apply to an existing contract, if the contract is renegotiated after the date of enactment.

d. Group-term life insurance purchased for employees (sec. 79)

Present Law

The cost of group term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost for $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance. Among the exceptions to this rule is one that applies to terminated employees who have reached retirement age or are disabled. As a result, an employer may provide group-term life insurance for these two groups of former employees in amounts greater than $50,000 without any portion of the costs being included in their gross income.

If a group-term life insurance plan maintained by an employer discriminates in favor of any key employee, the exclusion for the cost of the first $50,000 of this insurance is not available. In that event the full cost of the group-term life insurance for any key employee is included in the gross income of the employee (based on the uniform cost table).

The cost of an employee's share of group life insurance is determined on the basis of uniform premiums, computed with respect to 5-year age brackets. In the case of an employee who has attained age 64, the cost does not exceed the cost for a 63-year old individual.

Explanation of Provision

The bill effects three changes in the present-law treatment of group-term life insurance. First, the $50,000 limitation on the amount of group-term life insurance that may be provided tax-free to employees also will apply to retired as well as active employees.[27] The amendments do not alter the cost tables, however, so a retired employee's benefit will be computed at the age 65 cost.

Second, the nondiscrimination rules will be applied to plans covering retired employees. Thus, the cost of group-term coverage that is provided to retiring key employees will not be subject to any exclusion from gross income if the plan is found to be discriminatory. Third, under the bill, if a plan fails to qualify for the exclusion because it is discriminatory, then the employees and retirees will have to include in income the actual cost of their insurance benefit rather than the table cost prescribed by the Treasury.

Unless a plan is discriminatory, under the bill's provisions, a retired employee's benefit will be computed on the basis of the uniform cost tables. At age 65 the cost is presently $1.17 per thousand of excess insurance. Thus, a retiree age 65 who receives $100,000 of group-term coverage would recognize $702 of income which would have a maximum tax effect of $351. By contrast, the rate schedules of one major company set the premium for $100,000 of individual term coverage for a 65-year old male in excess of $3,000 per year.

Effective Date

The amendments made by this section shall apply to taxable years that begin after December 31, 1983.

The amendments made by this section do not apply to any group-term life insurance plan in existence on September 27, 1983 or to any group-term life insurance plan of the employer (or successor employer) which is a comparable successor to a plan existing on September 27, 1983. Generally, the term employer may be interpreted broadly to allow employee transfers between comparable plans offered by an affiliated group. Also, for these purposes a successor employer refers to a situation in which an employer assumes the group-term insurance obligations of another employer because of a business merger or acquisition, but does not refer to a new employer when an individual covered by a plan changes jobs and becomes covered by the new employer's group-term insurance plan. The exception from application of the new provisions, however, applies only to an individual who is covered by the plan on September 27, 1983, and only with respect to the amount of life insurance coverage of such individual on that date.

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[27] The bill would not apply the limitation to those who have terminated employment because of a disability.

4. Nondeductible Contributions to Individual Retirement Plans (sec. 4973 of the Code)

Present Law

An individual generally is entitled to deduct the amount contributed to an individual retirement account or annuity (referred to collectively as "IRAs"). The amount deductible for a taxable year is generally the lesser of 100 percent of compensation for the year or $2,000. The $2,000 deduction limit is increased to $2,250 for a year if (1) at least $250 is provided to the spouse of the individual, and (2) the spouse has no compensation for the year. Except for tax-free rollovers, no nondeductible contributions may be made to an IRA.

An annual excise tax applies to prohibited nondeductible contributions (*i.e.*, excess contributions) held in an IRA. The tax is 6 percent of the balance of the nondeductible contributions. Under present law, an individual is allowed a deduction from gross income for a taxable year if the individual corrects an excess contribution for a previous year by contributing less than the maximum amount allowable as a deduction for the year.[28]

Under present law, an individual is permitted to make a rollover contribution of a distribution from an IRA to another IRA without including the amount of the distribution in gross income. A tax-free rollover is generally allowed if the rollover occurs within 60 days of the date of the distribution. An individual is allowed to make a rollover contribution from an IRA once each year. Rollover contributions are not treated as excess contributions to an IRA and do not reduce the allowable deduction for a taxable year.

Income and gain on amounts held in an IRA are not taxed until distributed. Except in the case of certain correcting distributions or distributions rolled over to another eligible plan, all distributions from IRAs are includible in gross income when received. Distributions made before age 59-1/2 (other than those attributable to disability or death) are subject to an additional ten-percent income tax. If an individual borrows from an IRA or uses amounts as security for a loan, the transaction is treated as a distribution and the usual tax rules for distributions apply.

Distributions from an IRA must commence no later than the taxable year in which the individual attains age 70-1/2, and special rules require distributions to be made within a prescribed time after the individual's death. Amounts held in an IRA can qualify for exclusions under the estate tax and gift tax rules.

Present law requires that the trustee or issuer of an IRA make annual calendar year reports relating to the status of the IRA.[29]

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[28] The rule allowing a deduction for prior year contributions applies only to the amount of the excess contributions that do not exceed (1) the maximum allowable deduction for the year minus (2) the amounts contributed for the year.

[29] Treas. Reg. sec. 1.408-5.

This report must contain the following information for transactions during the calendar year: (1) the amount of contributions; (2) the amount of distributions; (3) in the case of an endowment contract, the amount of the premium paid allocable to the cost of life insurance; (4) the name and address of the trustee or issuer; and (5) such other information as the Commissioner may require. The annual report must be provided (1) to the individual on whose behalf the account is established or in whose name the annuity is purchased and (2) to the Internal Revenue Service.

Explanation of Provision

Under the provision, certain nondeductible IRA contributions (up to the nondeductible limit) are not treated as excess contributions subject to the six percent annual excise tax. The nondeductible limit for a taxable year is the least of (1) $1,750, (2) the excess of compensation includible in the individual's gross income for the year over the amount allowable as a deduction under the IRA rules, or (3) the amount of designated nondeductible contributions for the year.

A designated nondeductible contribution is any contribution to an IRA for a taxable year that the individual designates as a nondeductible contribution (up to the nondeductible limit). The designation may be made or revoked up to the day prescribed by law for filing the income tax return for the taxable year, including any extensions of time for filing to which the individual is entitled.

The committee intends that the individual's designation of nondeductible contributions will be made to the trustee or issuer accepting the IRA contributions. This rule is provided to aid the trustee or issuer of an IRA in maintaining records relating to the characterization of IRA amounts as nondeductible contributions, income on nondeductible contributions, and other amounts. The designation is also intended to assist the trustee or issuer in complying with the reporting requirements under the provision and with the annual reporting requirements of present law. With respect to the annual reporting requirements, the committee intends that the financial institution, when reporting contributions to an IRA, will specify the portion of any contribution that is designated as nondeductible contribution.

The trustee or issuer may specify a date by which a designation of nondeductible contributions must be made. For example, the trustee or issuer may specify that the designation must be made at the time the individual makes the IRA contribution. Alternatively, the trustee or issuer could specify a uniform date for final designation, such as April 15.

Under the provision, in any case in which nondeductible contributions are made on behalf of an individual and an individual's noncompensated spouse (within the meaning of the spousal IRA rules), the nondeductible limit for the taxable year may be allocated in any manner. For example, an individual could make contributions of $875 as designated nondeductible contributions to the individual's IRA and contributions of $875 as designated nondeductible contributions to the spousal IRA for the individual's noncompensated spouse. Alternatively, contributions of $1,750 of designated nondeductible contributions could be made to the spousal IRA.

Annual IRA contributions that exceed the sum of the amount allowable as a deduction for the taxable year and the nondeductible limit are treated as excess contributions that are subject to the annual six percent excise tax. Under the provision, if contributions in a later taxable year are less than the sum of (1) the amount allowable as a deduction for the taxable year and (2) the nondeductible limit, excess contributions from the prior year may be applied against the remaining amount allowable as a deduction and the remaining nondeductible limit, in the same manner as under present law. A designated nondeductible contribution could not, however, be recharacterized as a deductible contribution after the time for filing the tax return for the taxable year of the contribution (including extensions).

Under the provision, any amount paid or distributed from an IRA is treated first as paid or distributed from income and gain allocable to designated nondeductible contributions (to the extent thereof), second as paid or distributed out of designated nondeductible contributions (to the extent thereof), and then out of other amounts. If an IRA distribution includes property other than cash, the amount distributed is the fair market value of the property plus the amount of cash distributed. If appreciated property is distributed, the gain allocable to designated nondeductible contributions includes the unrealized appreciation. Losses incurred by an IRA would not be recognized by the IRA owner before all assets of the IRA have been distributed.

In general, any amount paid or distributed from an IRA is included in the gross income of the individual for the taxable year in which the payment or distribution is received. Amounts that are treated as paid or distributed out of designated nondeductible contributions, however, are treated as a return of basis and are excluded from gross income. Similar rules apply to distributions under an individual retirement annuity and, therefore, the general rules relating to the taxation of distributions under individual retirement annuity contracts are inapplicable.

For example, an individual's IRA could have accumulated designated nondeductible contributions of $10,000, income of $1,000 attributable to the designated nondeductible contributions, and other allowable amounts equal to $20,000. If the individual withdraws $15,000 from the IRA during a taxable year, $1,000 would be treated as coming from the income attributable to designated nondeductible contributions, $10,000 as attributable to the designated nondeductible contributions, and $4,000 as attributable to other allowable IRA contributions and income. In this case, the individual would include $5,000 in gross income for the taxable year (*i.e.*, $15,000 minus $10,000 treated as a return of basis). In addition, if the withdrawal occurs prior to the time the individual attains age 59-1/2, dies, or becomes disabled, $5,000 (the amount includible in gross income) is subject to the additional 10-percent income tax on premature distributions.

Under the provision, the trustee or issuer of an IRA is required to maintain any records necessary to account separately for designated nondeductible contributions and for the income and gain attributable to designated nondeductible contributions. In addition, under regulations prescribed by the Secretary of the Treasury, amounts that are rolled over, tax-free, from one IRA to another IRA must be accounted for in a manner that will retain the character of the amounts as designated nondeductible contributions, income on designated nondeductible contributions, or other amounts.

The committee intends that the trustee or issuer of an IRA will provide a report to the individual on whose behalf an account is established or in whose name an annuity is purchased. This report is to be provided to the individual at the time a payment or distribution is made from the IRA and is to contain information relating to the character (*i.e.*, designated nondeductible contributions, income attributable to designated nondeductible contributions, and other amounts) of the amounts paid or distributed. In addition, the committee intends that a copy of this report is to be supplied to the trustee or issuer of an IRA to which a rollover contribution from another IRA is made so that the character of the amounts rolled over is retained. Similarly, at any time a trustee-to-trustee transfer of IRA funds is made, any information relating to the character of the amounts transferred is to be supplied to the new trustee or issuer.

The report supplied at the time of a payment or distribution from an IRA is to be provided in addition to, and not in lieu of, the annual report required under present law.

Effective Date

The provision is effective for taxable years beginning after December 31, 1983.

5. Studies (sec. 241 of the bill)

Two issues that were of concern to the committee during the entire process of reformulating the tax structure applicable to life insurance companies were (a) the amount of Federal income tax paid by the companies in the life insurance industry and (b) the relative income tax burden borne by mutual and stock companies. The committee decided that it would be necessary to maintain close scrutiny of these two matters, and instructed that analytical reports be prepared on these two subjects.

Revenue reports

Each year on July 1, beginning in 1984, the Secretary of the Treasury is instructed to submit a report on the revenues received under the provisions of part 1, subchapter L for the most recent taxable year. The report is to be submitted to the Committee on Ways and Means and the Committee on Finance. Each report will present the aggregate amount of revenue received for the most recent taxable year for which data are available. The revenues are to be compared with the revenue estimates anticipated as a result of the changes made by TEFRA in 1982 and this bill. The reasons for any difference between the actual aggregate revenues and the revenues anticipated when the Acts were adopted are to be presented and analyzed.

Report on segment balance and other issues

The impact of new part 1, subchapter L on the different segments and products of the life insurance industry needs to be examined. A full and complete study of the effects of the provisions in this bill has been mandated, and the Secretary of the Treasury is instructed to conduct the study in consultation with the staffs of the Joint Committee on Taxation, the Committee on Ways and Means and the Committee on Finance. The study will examine the operation of the new tax provisions during 1984, 1985 and 1986.

The report shall include an analysis of the relative shares of life insurance company taxes paid by mutual and stock life insurance companies. The report also will consider any other data considered to be relevant by either stock or mutual life insurance companies in determining appropriate segment balance. Among the relevant variables for consideration are the amounts of the following items held by each segment of the industry: equity; life insurance reserves; other types of reserves; dividends paid to policyholders and shareholders; pension business; total assets, and gross receipts.

The study also is to include an analysis of life insurance products and their taxation. In addition, an analysis of whether the tax provisions in part I of subchapter L operate as a disincentive to growing companies will be included. The committee also instructed the Secretary to include in the report an analysis of the extent that taxes paid by stockholders of life insurance companies affect proper evaluation of segment balance.

In order to be able to conduct the study with as complete a fund of information that is possible, the Secretary of the Treasury is given authority to require reporting of data necessary for the study by life insurance companies with respect to the companies and their products.

The final report is to be submitted by January 1, 1989, to the Committee on Ways and Means and the Committee on Finance. Interim reports are to be submitted to the committees not later than July 1, 1986, 1987, and 1988.

D. Revenue Estimates Relating to Title II of the Bill

The estimated receipts for fiscal year 1984 under the life insurance tax amendments in title II of this bill are $2.8 billion, $3.0 billion in fiscal year 1985, and $3.3 billion in fiscal year 1986, or a total of $9.1 billion over the three-year period.

If the stopgap provisions which were enacted in 1982 in TEFRA would be extended without amendment, the estimated receipts in fiscal year 1984 would be $2.0 billion, $2.1 billion in fiscal year 1985, and $2.3 billion in fiscal year 1986, or a total of $6.4 billion over the three years.[30] If no action to respond to expiration of the stopgap provisions at the end of 1983 were taken, the revenue estimated for fiscal year 1984 would be $3.0 billion, and at $3.4 billion for fiscal year 1985, and $3.7 billion for fiscal year 1986, or a total of $10.1 billion over the three years.[31]

The nondeductible IRA provisions of the bill will reduce fiscal year budget receipts by $15 million in 1984, $65 million in 1985, $135 million in 1986, $209 million in 1987, and $285 million in 1988, or a total of $709 million over five years.

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[30] The estimates given at the time the conference report on TEFRA was agreed to would have indicated an estimate of $3.3 billion in fiscal year 1984, $3.5 billion in fiscal year 1985, and $3.6 billion in fiscal year 1986 (a total of $10.4 billion over three years) if stopgap were extended.

[31] The estimates for expiration of stopgap given at the time of the TEFRA conference report were $4.6 billion for fiscal year 1984, $4.8 billion for fiscal year 1985, $5.1 billion for fiscal year 1986 (a total of $14.5 billion over the three years).

TITLE III—REVISION OF PRIVATE FOUNDATION PROVISIONS

A. Limitations on Deduction for Contributions to Private Foundations (Sec. 302 of the bill and Code sec. 170)

Present Law

Percentage limitations

Under present law (Code sec. 170), contributions of cash and ordinary-income property by an individual to public charities or private operating foundations are deductible up to 50 percent of the donor's adjusted gross income. (The 50-percent limitation applies to such contributions made to a private nonoperating foundation only if the donee either redistributes all contributions within a specified period after receipt or qualifies as a "pooled fund" foundation.) For contributions of certain capital-gain property to organizations otherwise qualifying for the 50-percent limitation, the limitation generally is 30 percent. In the case of contributions to private nonoperating foundations (other than the two categories eligible for the 50-percent/30-percent limitations), present law retains the lower percentage (20 percent) that has generally been applicable to private foundations since the 1954 Code (sec. 170(b)(1)(B)).

Contributions by individuals which exceed the 50-percent/30-percent limitations may be carried forward and deducted over the following five years, subject to applicable percentage limitations in those years (sec. 170(d)). Under present law, there is no carryover of excess deduction amounts if the 20-percent limitation applies.

Contributions of appreciated property

Under present law, in the case of donations by individuals of capital-gain property to private nonoperating foundations as to which the 20-percent limitation applies, the amount deductible equals the asset's fair market value reduced by 40 percent of the unrealized appreciation (i.e., by 40 percent of the amount by which the value exceeds the donor's basis in the property). In the case of donations by individuals of certain capital-gain property to public charities, etc., where the 30-percent limitation applies, there is no reduction from fair market value.

Reasons for Change

The committee believes that the failure of present law to provide a carryover deduction in the case of excess contributions to private nonoperating foundations merely requires the donor to divide a planned large gift to a nonoperating foundation into smaller amounts contributed over several years. Accordingly, the committee believes that extension of the carryover rules to contributions to nonoperating foundations is not inconsistent with longstanding Federal tax policy that provides a tax advantage to contributions to public charities and operating foundations.

Because as a general rule public charities and operating foundations directly carry out charitable functions, expend charitable donations more promptly, and have public involvement, support, and supervision, the committee believes that a tax preference for contributions to public charities and operating foundations continues to be appropriate. However, the committee acknowledges the substantial role of nonoperating foundations in private philanthropy and believes that the extent of this tax preference should be narrowed by increasing to 30 percent the deduction limitation for gifts of cash and ordinary-income property to nonoperating foundations.

Finally, the committee believes that deductibility at full fair market value for gifts of appreciated stock to private nonoperating foundations should be permitted in certain situations in which the potential for abuse, including overvaluations, is minimized.

Explanation of Provisions

Carryover of excess contributions

Under the bill, the five-year carryover deduction for excess contributions by individuals (sec. 170(d)) is extended to contributions to private nonoperating foundations.

Percentage limitations

In addition, the 20-percent limitation which applies under present law for charitable contributions by individuals to private nonoperating foundations (and certain other charitable contributions) is increased by the bill to 30 percent in the case of contributions of cash and ordinary-income property. The bill retains the 20-percent limitation for all gifts of capital-gain property except such gifts to public charities or private operating foundations. Thus, gifts of capital-gain property to private nonoperating foundations (including gifts of certain appreciated stock which are deductible under the bill at fair market value) are subject to the 20-percent limitation.

Amount deductible for certain stock

The bill also provides that, effective for a ten-year period, contributions to private nonoperating foundations of certain qualified appreciated stock are deductible at full fair market value. Thus, the general present-law rule applicable to gifts of capital-gain property to nonoperating foundations, which limits the amount deductible to the asset's fair market value reduced by 40 percent of the unrealized appreciation, will not apply to such contributions of qualified appreciated stock.

The term qualified appreciated stock means any stock of a corporation (1) for which (as of the date of the contribution) market quotations are readily available on an established securities market and (2) which is capital-gain property for purposes of the charitable contribution deduction rules (sec. 170(b)(1)(C)(iv)). The increased deduction under the bill applies only to the extent that the cumulative total of donations by a donor to all private nonoperating foundations of stock in a particular corporation is less than 10 percent of the value of all outstanding stock of that corporation. For this purpose, a donor is treated as making contributions that are made by any member of the donor's family (as defined in sec. 267(c)(4)).

Effective Date

The amendments made by section 302 of the bill apply to contributions made in taxable years beginning after December 31, 1984. The special rule for contributions of qualified appreciated stock will not apply to contributions made after December 31, 1994.

B. Exemption for Certain Operating Foundations from Excise Tax on Investment Income and Expenditure Responsibility Rules (Sec. 303 of the bill and Code secs. 4940 and 4945)

Present Law

Under present law, a private foundation is subject to a two-percent excise tax on the sum of its gross investment income (including interest and dividends) plus net capital gain, less the expenses of earning such amounts (Code sec. 4940). No similar tax is imposed on investment income of public charities.

In the case of grants to organizations other than public charities, a private foundation must exercise expenditure responsibility over the grant in order to avoid the excise tax on taxable expenditures (sec. 4945).

Reasons for Change

The committee believes that private operating foundations which exhibit certain characteristics reflecting substantial public involvement should be exempted from the two-percent excise tax on net investment income, and that foundations making grants to such organizations should not be required to comply with the expenditure responsibility rules. These changes will assist such operating foundations in making direct expenditures for the active conduct of their charitable activities. At the same time, these foundations will remain subject to other private foundation rules, such as the prohibitions on self-dealing and taxable expenditures.

Explanation of Provisions

The bill provides that exempt operating foundations are not subject to the two-percent excise tax on investment income (sec. 4940), and that grants from other foundations to exempt operating foundations are not subject to the expenditure responsibility requirements under section 4945.

The bill defines exempt operating foundation to mean, with respect to any taxable year, any private operating foundation[1] (1)

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[1] In general, a private operating foundation is defined (sec. 4942(j)(3)) as a foundation that expends directly for the active conduct of its exempt activities at least 85 percent of the lesser of (a) its adjusted net income or (b) its minimum investment return (i.e., five percent of the value of its investment assets). Also, the foundation must meet one of three tests relating to its use of assets, operating expenditures, or support.Under the first test, 65 percent or more of the assets of the foundation must be devoted directly to the active conduct of its exempt activities or to

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which either has been publicly supported (under secs. 170(b)(1)(A)(vi) or 509 (a)(2)) for at least 10 taxable years, or qualified as an operating foundation on January 1, 1983; (2) the governing body of which, at all times during the taxable year, consists of individuals at least 75 percent of whom are not disqualified individuals, and also is broadly representative of the general public; and (3) no officer of the foundation is, at any time during the taxable year, a disqualified individual.

The bill defines disqualified individual as an individual who is (i) a substantial contributor to the foundation; (ii) an owner of more than 20 percent of the total combined voting power of a corporation, the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise, which corporation, partnership, or enterprise is a substantial contributor to the foundation; or (iii) a member of the family of any individual described in (i) or (ii). For this purpose, the term substantial contributor means a person who is described in section 507(d)(2), and the term family has the meaning given to such term by section 4946(d). In determining ownership in a corporation, etc., for purposes of the definition of disqualified individual, the constructive ownership rules of sections 4946(a)(3) and (4) apply.

Effective Date

The exemption from the section 4940 excise tax for certain operating foundations applies to taxable years beginning after December 31, 1984. The exemption from the expenditure responsibility rules applies to grants made after 1984.

C. Reduction in Section 4940 Excise Tax Where Charitable Payout Increases (Sec. 304 of the bill and Code sec. 4940)

Present Law

The Tax Reform Act of 1969 imposed a four-percent excise tax on the net investment income of private foundations, i.e., on the sum of gross investment income (including interest and dividends) plus net capital gain, less expenses of earning such income (Code sec. 4940). The tax was imposed so that foundations would share some of the costs of government, particularly the costs of administering the tax laws relating to exempt organizations. In the Revenue Act of 1978, the Congress reduced the tax rate to two percent, noting that the prior rate had produced more than twice the revenue needed to finance administration by the Internal Revenue Service of the exempt organization provisions of the Code.

Present law (sec. 4942) in effect requires a private nonoperating foundation to make qualifying distributions, by the end of the following year, at least equal to five percent of the value of its investment assets for the year, less the amount of section 4940 tax on the

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functionally related businesses. Under the second test, the organization must normally spend an amount not less than two-thirds of its minimum investment return directly for the active conduct of its exempt activities. Under the third alternative test, the organization must receive at least 85 percent of its support from five or more exempt organizations and from the general public, and not more than 25 percent of the foundation's support may be received from any one exempt organization.

foundation's net investment income for the year. The payout rules under section 4942 do not apply to private operating foundations; however, to qualify for operating status, a private foundation must meet certain payout requirements.[2]

Reasons for Change

The committee was informed that the amount of taxes collected under section 4940 during fiscal year 1982 totalled approximately $93 million. The Internal Revenue Service estimates that the total costs of administering the combined exempt organization and employee plan programs in fiscal year 1982 were approximately $84.5 million, of which $33.4 million was for exempt organizations and about $51.1 million for employee plans.

Thus, section 4940 excise tax collections continue to exceed the costs of administering not only the exempt organization program, but also the employee plan and exempt organization programs combined. The amounts raised by this excise tax are not earmarked for the administration of these programs; rather, they go into general revenues. The amount of funds available to the Internal Revenue Service generally continues to depend on annual Treasury appropriations.

In light of these considerations, the committee believes that the rate of the section 4940 excise tax should be reduced from two percent to one percent, but only where there is an equivalent increase in the foundation's qualifying distributions for charitable purposes.

Explanation of Provision

The rate of the section 4940 excise tax imposed on the net investment income of a private foundation is reduced from two percent to one percent for any taxable year if the amount of qualifying distributions[3] made by the foundation during such taxable year equals or exceeds the sum of (a) an amount equal to the foundation's assets[4] for such taxable year multiplied by the average percentage payout for the base period, plus (b) one percent of the foundation's net investment income for such taxable year. The tax rate is not reduced for a year if the foundation's average percentage payout for the base period is less than five percent (3⅓ percent in the case of a private operating foundation).

A foundation's percentage payout is computed for a year by dividing (i) the amount of qualifying distributions made by the foundation during the taxable year, by (ii) the foundation's assets for the taxable year. (If the amount of section 4940 tax for any taxable year in the base period is reduced by reason of this provision, the amount of qualifying distributions made by the foundation during such year is to be reduced for purposes of this computation by the amount of such reduction in tax.) The average percentage payout for the base period is the average of the percentage payouts for taxable years in the base period.

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[2] See note 1, *supra*.

[3] For this purpose, the term qualifying distribution has the same meaning as in section 4942(g).

[4] The assets of the foundation, for this purpose, equal the excess of (1) the aggregate fair market value of all assets of the foundation other than those which are used (or held for use) directly in carrying out the foundation's exempt purposes, over (2) the acquisition indebtedness with respect to such assets (determined under sec. 514(c)(1) without regard to the taxable year in which the indebtedness was incurred).

In general, the base period is the five taxable years preceding the current year. If a private foundation has not been in existence for five years, the base period consists of the years during which the foundation was in existence.

In the case of a private foundation which is a successor to another foundation, the experience of the predecessor is to be taken into account in applying this provision. Treasury regulations are to prescribe rules for applying this provision where there has been a merger, reorganization, or division of a private foundation.

Effective Date

The amendment made by section 304 of the bill applies to taxable years beginning after December 31, 1984.

D. Amendments to Payout Requirements (Sec. 305 of the bill and Code sec. 4942)

Present Law

The Tax Reform Act of 1969 in effect required private nonoperating foundations to make payouts at a specified minimum level, generally either (1) as direct expenditures to accomplish charitable purposes, or (2) as grants to public charities or private operating foundations. All administrative expenses incurred for such charitable purposes count as qualifying distributions. If certain requirements are met, a foundation may count as current distributions amounts "set aside" to be paid within five years for a specific project.

As enacted in 1969, the payout provision had required foundations to make qualifying distributions equal to the higher of (1) the foundation's net income (other than long-term capital gains) or (2) the foundation's minimum investment return—then set at six percent of the fair market value of the foundation's investment assets, with that rate subject to certain adjustments for post-1970 years. The Tax Reform Act of 1976 substituted a flat five-percent rate for measuring the minimum investment return. In 1981, the Economic Recovery Tax Act (ERTA) repealed the prior-law rule that had required foundations to distribute any excess of net income over the minimum investment return. Thus, to avoid excise tax under present law, a private nonoperating foundation must make qualifying distributions, by the end of the following year, at least equal to five percent of the fair market value of its investment assets for the year, less the amount of section 4940 tax on the foundation's net investment income for the year.

The payout rules under section 4942 do not apply to private operating foundations. However, to qualify for operating status, a private foundation must meet certain payout requirements.[5]

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[5] See note 1, *supra*.

Reasons for Change

The committee believes that a reasonable limitation should be placed on the extent to which grant administrative expenses may be counted in satisfaction of the payout requirement, in order to ensure that more foundation expenditures actually reach charitable beneficiaries.

Explanation of Provisions

Grant administrative expenses

Under the bill, the amount of grant administrative expenses paid during a taxable year which may be taken into account as qualifying distributions may not exceed the excess (if any) of (1) 15 percent of the aggregate amount of qualified grants made by the foundation during the year and the immediately preceding four taxable years, over (2) the aggregate amount of grant administrative expenses paid during the four preceding taxable years which were taken into account as qualifying distributions.

The 15-percent limitation applies to administrative expenses (such as wages) which are allocable to the making by the foundation of any contribution, gift, or grant which is a qualifying distribution. If a payment by a foundation is a contribution, gift, or grant which is a qualifying distribution, then all administrative expenses allocable to the payment are grant administrative expenses. A set-aside which is made for purposes of making a contribution, gift, or grant constitutes a contribution, gift, or grant in the taxable year in which treated as a qualifying distribution, and administrative expenses allocable to such a set-aside are grant administrative expenses.

The 15-percent limitation does not apply with respect to administrative expenses incurred by a foundation directly for the active conduct of its exempt activities.[6] For example, if one activity of a private foundation is to provide direct assistance to other charities in conducting their own programs and in their fund raising, the salary of the foundation's employee who does such work at the other charity for a period of time does not constitute a grant administrative expense.[7] Administrative expenses which, without respect to the 15-percent limitation, may not be counted as qualifying distributions (e.g., administrative expenses incurred in the production of investment income) do not enter into the computation of the 15-percent limitation.

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[6] For purposes of the definition of operating foundations under section 4942(j), all administrative expenses (such as staff salaries and traveling expenses) necessary to conduct a foundation's exempt activities, regardless of whether they are directly for the active conduct of such exempt activities, are treated as qualifying distributions expended directly for the active conduct of such exempt activities if such expenses and costs are reasonable in amount (Treas. Reg. sec. 53.4942(b)-1(b)(1)). This allocation rule does not apply for purposes of the 15-percent limitation.

[7] The following illustrates the application of these rules. Assume that X Foundation is a private nonoperating foundation whose principal purpose is to relieve poverty and human suffering. The Foundation has a salaried staff of employees located in various areas of the country. Three-fourths of the Foundation's expenditures consist of grants to charitable organizations; the remaining one-fourth is for operation of a soup kitchen and other direct delivery services (e.g., the furnishing of temporary shelter).The administrative expenses incurred by the X Foundation in its grantmaking activities are considered grant administrative expenses. The administrative expenses associated with operation of the soup kitchen and other direct delivery services performed by the Foundation are not considered grant administrative expenses for purposes of this provision. That is, the expenses of the direct providing by the Foundation through its employees of food and shelter to individuals through operation of the soup kitchen and the shelter are treated as incurred directly for the active conduct of the Foundation's exempt activities, rather than as expenses allocable to contributions of food and shelter.

Under a transitional rule, the amount of grant administrative expenses in any base period year which began before January 1, 1985 will be treated as constituting no more than 15 percent of the foundation's qualified grants in that year. For example, if during 1983 the actual grant administrative expenses of a calendar-year foundation amounted to 25 percent of qualified grants, the computation of the limitation for 1985 would assume that the percentage for 1983 was only 15 percent.

The 15-percent limitation applies with respect to the section 4942 payout rules and does not affect other foundation tax rules applicable to payments of expenses by a private foundation. Thus, the payment of excessive compensation to a foundation manager would constitute an act of self-dealing under section 4941(d) and a taxable expenditure under section 4945(d)(5), whether or not such expenses caused the 15-percent limitation to be exceeded. On the other hand, the mere fact that a foundation's grant administrative expenses exceeded the 15-percent limitation would not itself establish that any of such expenses constitute, for example, taxable expenditures under section 4945(d)(5).

Technical amendment

In ERTA, section 4942 was amended to define the required minimum payout as five percent of the value of the foundation's net investment assets (rather than the higher of that figure or net income). The ERTA amendment failed to add back to the newly defined payout amount the previously applicable modifications set forth in section 4942(f)(2)(C), relating to (i) repayments to the foundation of amounts previously treated as qualifying distributions (e.g., scholarship loans); (ii) amounts received on disposition of assets previously treated as qualifying distributions; and (iii) amounts previously set aside for a charitable project but not so used.

The bill adds to the required minimum payout the amounts specified in Code section 4942(f)(2)(C) (certain loan repayments, proceeds from asset dispositions, and unused set-asides).

Effective Date

The amendments made by section 305 of the bill apply to taxable years beginning after December 31, 1984.

E. Abatement of First-Tier Excise Taxes in Certain Cases (Sec. 306 of the bill and Code secs. 4942-4945)

Present Law

First-tier sanctions

Under present law, any violation of the foundation rules (secs. 4941-4945) results in imposition of an initial excise tax on the foundation (or in the case of self-dealing, on the disqualified person who entered into the prohibited transaction with the foundation). For example, a violation of the prohibitions on self-dealing transactions or jeopardizing investments triggers an excise tax equal to five percent of the amount involved in the self-dealing transaction (sec. 4941) or the jeopardizing investment (sec. 4944), payable for each year (or part thereof) in the taxable period. This means that the tax under section 4941 or 4944 continues to be imposed each year beginning when the prohibited act occurs and ending only when the Internal Revenue Service issues a deficiency notice or assesses tax on the act, or when the prohibited act is "corrected."

In general, the first-tier excise tax on the foundation (or on the disqualified person engaged in self-dealing) applies automatically when a foundation rule is violated. However, where a foundation fails to satisfy the section 4942 payout requirements solely as a result of an incorrect asset valuation which was due to reasonable cause, the excise tax under that section is excused if the payout deficiency is made up during a specified period.

If there is a violation of the prohibitions on jeopardizing investments, taxable expenditures, or self-dealing, an initial excise tax is imposed on any foundation officer, director, trustee, or responsible employee who knowingly participated in the prohibited act, unless the manager had reasonable cause to excuse participation in the act. This first-level tax on the manager cannot exceed $5,000 ($10,000 in the case of self-dealing) for any one such violation.

Second-tier sanctions

If a violation of the foundation rules (secs. 4941-4945) is not "corrected" within a specified period, an additional excise tax is imposed on the foundation (or in the case of self-dealing, on the disqualified person). For example, a second-tier tax equal to 200 percent of the amount involved in a self-dealing transaction would be imposed on the disqualified person unless (1) the prohibited transaction is undone to the extent possible and (2) the foundation is placed in a financial position not worse than it would be had the disqualified person dealt with the foundation under the highest fiduciary standards.

Similarly, an additional excise tax is imposed on a foundation manager who refuses to agree to correct a violation of the prohibitions on self-dealing, jeopardizing investments, or taxable expenditures. The second-tier tax on the manager cannot exceed $10,000 for any one such violation.

Additional penalties

If a foundation rule violation is willful and flagrant,[8] or if there has been a prior violation of any foundation rule, the excise tax sanctions are doubled, unless the violation was due to reasonable cause (sec. 6684). In addition, a termination tax (sec. 507) may be imposed on the foundation if the violation was willful and flagrant or there have been "willful repeated"[9] violations.

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[8] An act or failure to act violating a foundation rule is deemed willful and flagrant if it is "voluntarily, consciously, and knowingly" committed in violation of any said rule and if it "appears to a reasonable man to be a gross violation ***" (Treas. Reg. sec. 1.507-1(c)(2)). No motive to avoid the foundation restrictions is necessary to make an act or failure to act willful. However, an act or failure to act is not willful if the foundation (or a manager, if applicable) does not know that it is an act to which the foundation rules apply (Treas. Reg. sec. 1.507-1(c)(5)).

[9] For this purpose, the term willful repeated violations means at least two acts or failures to act both of which are "voluntary, conscious, and intentional" (Treas. Reg. sec. 1.507-1(c)(1)).

Reasons for Change

The committee believes that the present-law automatic first-tier penalties are stricter than necessary to enforce the foundation requirements in certain circumstances. Therefore, in those instances where it can be shown that there was reasonable cause for the violation (other than self-dealing) and there was no willful neglect of the rules, the Internal Revenue Service should have discretionary authority to relieve the foundation from the first-tier penalty tax, provided that the foundation corrects the violation. The committee finds no justification for extending such an abatement mechanism to acts of self-dealing, particularly since the penalty tax for such violations is payable by the self-dealer, not by the foundation, and since under current law commercial transactions between disqualified persons and foundations are generally prohibited.

Explanation of Provision

The bill provides discretionary authority to the Internal Revenue Service to abate first-tier chapter 42 private foundation taxes, other than the section 4941(a) tax on self-dealing, if it is established to the satisfaction of the Service that the violation of the foundation rules (1) was due to reasonable cause and not to willful neglect and (2) has been corrected within the appropriate correction period. A violation which was due to ignorance of the law is not to qualify for such abatement.

Effective Date

The amendments made by section 306 of the bill apply to taxable events occurring after December 31, 1984.

F. Amendment to Voter Registration Rules (Sec. 307(a) of the bill and Code sec. 4945(f))

Present Law

Under present law, an excise tax is imposed on private foundation expenditures for nonexempt purposes, including expenditures for political activities (sec. 4945). Expenditures paid or incurred by a foundation to influence the outcome of any specific election or to carry on, directly or indirectly, voter registration activities generally are taxable expenditures (sec. 4945(d)(2)).

However, current law provides an exception for amounts paid to, or incurred by, certain organizations that are engaged in nonpartisan voter registration activities if the following requirements are met (sec. 4945(f))—

(1) The organization must be described in section 501(c)(3) and exempt from income tax under section 501(a);

(2) The voter registration activities must be nonpartisan, must not be confined to one specific election period, and must be carried on in at least five States;

(3) The organization must spend at least 85 percent of its income directly for the active conduct of activities constituting the purpose for which it is organized and operated;

(4) The organization must receive at least 85 percent of its total support (other than gross investment income) from other exempt organizations, the general public, governmental units, or any combination of these sources. However, the organization may not receive more than 25 percent of such support from a single exempt organization, nor may it receive more than 50 percent of its support from investment income; and

(5) Contributions to the organization for voter registration activities must not be subject to conditions that they be used only in specified States, political subdivisions, or other areas of specified States, or that they may be used only in one specific election period.

Reasons for Change

Present law is intended both to encourage private foundation support for certain nonpartisan voter registration activities, and to preclude private foundations from engaging in narrowly limited activities which are designed to favor particular candidates and which are partisan in nature. The committee believes that elimination of the "five State rule," while retaining all other requirements under current law, is consistent with these objectives. In addition, the committee notes that any donee organization which may engage in foundation-supported voter registration activities must be tax-exempt under section 501(c)(3), and therefore is prohibited from engaging in partisan activities.

Explanation of Provision

The bill repeals the requirement that a private foundation may support a voter registration drive only if the drive is conducted in at least five States, but retains all other requirements of present law (sec. 4945(f)). Thus, as under present law, the activities of the organization conducting the voter registration drive must be nonpartisan, and cannot be confined to one specific election period, and contributions to the organization for voter registration drives may not be limited to use in specified States, or political subdivisions or other areas thereof, or in one specific election period.

Effective Date

The amendment made by section 307(a) of the bill takes effect on January 1, 1984.

G. Definition of Family Member (Sec. 307(b) of the bill and Code sec. 4946(d))

Present Law

The tax rules applicable to private foundations in effect prohibit certain transactions or holdings involving a disqualified person and a private foundation. Under present law, the term disqualified person includes substantial contributors to a foundation, foundation officers, directors, or trustees, and members of the family of such an individual, plus certain other related entities. The disqualified family members are the individual's spouse, ancestors, and all lineal descendants (and their spouses) (sec. 4946(d)).

Reasons for Change

The committee believes that, weighing the difficulties of keeping track in perpetuity of all lineal descendants of a disqualified person against the need to preserve the integrity of the foundation rules, it is appropriate to include only children, grandchildren, and great-grandchildren (and their spouses) in lineal descendants who are disqualified persons by reason of being members of a disqualified person's family.

Explanation of Provision

The bill provides that lineal descendants of a disqualified person who are considered members of the family of that individual, and as such, disqualified persons, are the individual's children, grandchildren, and great-grandchildren, and the spouses of such descendants.

Effective Date

The amendment made by section 307(b) takes effect on January 1, 1985.

H. Public Disclosure and Accessibility of Information on Foundations to Grant Applicants (Sec. 307(c) of the bill and Code sec. 6104(d))

Present Law

Annual returns

A private foundation must file an annual information return (Form 990-PF) with the Internal Revenue Service and furnish a copy of the return to the Attorney General (or other official) in the relevant State (sec. 6033).

The Form 990-PF includes the following information for the taxable year: gross income and related expenses, disbursements, a balance sheet showing assets, liabilities, and net worth, total contributions and gifts received, the names and addresses of all substantial contributors, the names and addresses of the foundation managers and highly compensated employees, and the compensation and other amounts paid to the foundation managers and highly compensated employees. Also, the return currently requests certain information regarding applications for grants from the foundation (name, address, and telephone number of the person to whom applications should be addressed; any required format, information, and materials; deadlines for submitting applications; and any limitations on the types of awards that the foundation makes, such as by geographical areas, charitable fields, kinds of donee institutions, etc.).

The failure to file a timely exempt organization information return (unless reasonable cause is shown) results in a sanction of $10 per day, up to a maximum of $5,000 as to any one return, imposed on the organization (sec. 6652(d)). Failure to file a return after a reasonable demand by the Internal Revenue Service (unless reasonable cause is shown) results in an additional sanction of $10 per day, up to a maximum of $5,000 as to any one return, imposed on the exempt organization officer or employee who fails to file the information return.

Disclosure requirements

Under present law, all information required to be furnished on the private foundation annual return must be made available to the public by the Internal Revenue Service (sec. 6104).

In addition, a copy of the private foundation annual return must be made available, at the principal office of the foundation, to any citizen who requests to inspect the return within 180 days after a notice of availability has been published (sec. 6104(d)). This notification must be published in a newspaper with general circulation, in the county in which the foundation's principal office is located, not later than the due date for filing the return. The published notice must state the address of the private foundation's principal office and the name of its principal manager.

Finally, the Internal Revenue Service is required to notify the Attorney General (or other official) of the relevant State in the event of (1) denial of tax-exempt status to an organization, (2) the operation of a charitable organization in a manner that fails to meet the requirements for tax-exempt status, or (3) the mailing of a notice of deficiency regarding taxes imposed on private foundations (sec. 6104(c)). In addition, the Service is to make available to such State officials information about the preceding items that are relevant to any determination under State law.

Reasons for Change

The committee believes that the private foundation reporting and disclosure requirements provide valuable information both for public information purposes and for tax administration purposes. Because the General Accounting Office has concluded that the Internal Revenue Service has not fully been attentive to enforcing the annual return requirements relating to information primarily beneficial to the public, the committee believes that the Service should intensify its enforcement activities to ensure availability of this information.

Also, the committee believes that the required newspaper notice should include the foundation's telephone number, as an aid to grant applicants.

While the committee is aware of the various resources presently available to grant applicants, the general public may still experience difficulties in obtaining all information needed about foundation grantmaking. This problem would be alleviated if all private foundations provided the public with information in an accessible and understandable format, for example, through annual reports.

Explanation of Provision

The bill provides that the annual notice of availability of the private foundation annual return, which is required to be published in a newspaper, must contain the telephone number for the foundation's principal office.

Also, the committee directs the Internal Revenue Service to enforce fully the present law rules relating to private foundation annual information returns (Form 990-PF), including the imposition, in appropriate cases, of penalties for failure to file a (complete) return where the return as filed fails to provide all required information. The committee also calls upon the Service to facilitate the flow of appropriate information to those State officials who are entitled to such information, and to coordinate more closely with the States to maximize the benefits to be derived from such information.

Effective Date

The amendment made by section 307(c) of the bill takes effect on January 1, 1985.

I. Amendments to Excess Business Holdings Rules (Secs. 308-311 and 315(b) of the bill and Code sec. 4943)

Present Law

General rules

In 1969, the Congress was concerned that managers of foundations which owned large holdings in a business tended to be relatively unconcerned about producing income to be used in charitable activities, that their attention and interest would be devoted to the operation, maintenance, and improvement of the business while neglecting exempt activities, and that businesses owned by exempt organizations may be operated in a way that provides those businesses with a competitive advantage over businesses owned by taxable persons. In general, the Congress concluded that a private foundation should be limited in the amount of a business which it may control.

The Tax Reform Act of 1969, in effect, generally limited the combined ownership of a business corporation by a private foundation and disqualified persons (for this purpose, including certain related foundations) to not more than 20 percent of the voting stock.[10] (For example, if the disqualified person's holdings are five percent, the foundation itself may hold only 15 percent.) If persons other than disqualified persons have effective control of the corporation, the combined foundation/disqualified person holdings are limited to 35 percent. A private foundation may not conduct any business as a proprietorship.

Under a de minimis rule, there are no excess business holdings if a private foundation (together with related foundations) owns not more than two percent of the voting stock and not more than two percent of the value of all classes of stock, regardless of the extent of ownership by disqualified persons. Also, there are no percentage limitations on foundation ownership of a business which is functionally related to the foundation's charitable programs, or of a business deriving 95 percent of its gross income from certain passive sources.

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[10] If all disqualified persons together do not own more than 20 percent of the voting stock of a corporation, there is no limit on the nonvoting stock which may be held by the private foundation. To determine permitted holdings in a partnership, the foundation's "profits interest" is aggregated with the profits interests of all disqualified persons and substituted for the voting stock limitation applicable to corporations, and "capital interest" is used in place of nonvoting stock. In computing the holdings of any business enterprise, stock or other interests owned, directly or indirectly, by a corporation, partnership, estate, or trust are considered as owned proportionately by the beneficial owners.

Holdings in excess of permitted limits which are acquired after May 26, 1969 other than by purchase (e.g., by gift or bequest) must be disposed of by the foundation within five years after acquisition (sec. 4943(c)(6)). Post-May 26, 1969 purchases of stock by a foundation or a disqualified person which create or increase aggregate holdings beyond permitted limits do not qualify for the five-year grace period, and may immediately result in excise tax penalties on the foundation (subject to a 90-day grace period for a foundation to reduce its holdings as required after purchases by a disqualified person).

Grandfathered holdings

The 1969 Act provided special rules applicable where the business holdings of a private foundation (combined with disqualified persons) exceeded the 20-percent/35-percent limitation on May 26, 1969. These special rules also apply to holdings acquired under trusts irrevocable on that date, or certain wills executed by that date, even though the actual transfer to the foundation occurs later. In general, grandfathered holdings are permitted to be retained, but are subject to gradual reduction over several phases.

Under the first phase, by the deadlines shown below the combined foundation/disqualified person holdings cannot exceed 50 percent of the voting stock of the corporation or, if less, 50 percent of the value of all outstanding shares—

Ownership on 5/26/69:	**Deadline to reach 50% combined holdings:**
More than 95% by foundation alone	May 26, 1989
More than 75% combined holdings	May 26, 1984
More than 50% combined holdings	May 26, 1979

After expiration of the first phase, a second set of divestiture requirements becomes operational—

(1) If disqualified persons do not own more than two percent of the corporate voting stock at any time during the second phase (the 15 years after the close of the first phase), the combined foundation/disqualified person holdings must be reduced to not more than 35 percent by the end of that period (i.e., for a foundation which itself owned 95 percent of the stock on May 26, 1969, by May 26, 2004); and if at any time after the end of the second phase the holdings of disqualified persons exceed two percent, then the foundation itself cannot hold more than 25 percent of the voting stock.

(2) If the holdings of disqualified persons exceed two percent at any time during the second phase, then at all times thereafter the combined foundation/disqualified person holdings are limited to 50

percent, with no more than 25 percent of the voting stock being held by the foundation.

Grandfathered holdings are subject to reduction by operation of the "downward ratchet" rule. The rule, in effect, provides that if there is any reduction in the holdings of a private foundation or in combined private foundation/disqualified person holdings, then these holdings can never go up again to the former grandfathered or otherwise permitted level over 20 percent (35 percent, if applicable).

Reasons for Change

After review of the general limitations on business holdings by foundations, the committee believes that the same reasons for which in 1969 the Congress prohibited private foundations from owning substantial holdings of a business enterprise continue to be valid today. The committee continues to believe that the attention and energies of private foundations should be directed toward performance of their exempt functions and not toward the operation of a business enterprise. The committee believes that without such restrictions, the energies and resources of the private foundation may well be directed toward the operation of the business enterprise. Where the charitable ownership predominates, the business also may be run in a way which unfairly competes with other businesses. Moreover, ownership of significant interests in business enterprises makes the provisions relating to self-dealing, minimum payout, and taxable expenditures difficult to administer.

In addition, the committee believes that the 1969 Act rules requiring divestiture of pre-1969 holdings by private foundations continue to be appropriate for several reasons. First, the same reasons for prohibiting private foundations from acquiring significant interests in business enterprises after 1969 apply to pre-1969 holdings. Second, since the enactment of the 1969 Act, many private foundations have divested themselves of their excess business holdings in reliance on the mandates of the 1969 Act. The committee believes that it would be unfair to those private foundations who properly relied on and complied with the law to permit those private foundations who have failed to comply with the 1969 Act rules to now become exempt from divestiture.

After reviewing the 1969 Act rules, the committee also has concluded that certain modifications to those rules are desirable in order to carry out the overall intent of the 1969 Act.

First, the committee believes that the rules which require divestiture within five years of excess business holdings acquired by a private foundation after 1969 other than by purchase may not provide sufficient time to dispose of holdings which are exceptionally large or complex. Accordingly, the bill provides the Internal Revenue Service with discretionary authority to extend the normal five-year divestiture period for an additional five years in appropriate cases involving an unusually large gift or bequest of diverse or complex business holdings.

Second, the committee believes that the operation of the "downward ratchet" rule is too harsh in certain situations. For example, since the enactment of the 1969 Act, it is now possible for a business enterprise to adopt an employee stock ownership plan (ESOP) to which the stock of the enterprise is contributed for the benefit of its employees. Often this stock is later redeemed from the ESOP as those employees terminate their employment. Under the downward ratchet rule, the private foundation's relative holdings decrease when the stock is transferred to the plan; as a result, when the stock is redeemed from the plan, the private foundation is forced to sell some of its otherwise permitted holdings to reduce its relative holdings to the new lower limit. The committee believes that the downward ratchet rule should not apply where the reductions in the relative holdings of the private foundation result from new issuances of stock so long as the reduction is relatively minor. Accordingly, the bill provides an exception to the downward ratchet rule where the reduction of the relative holdings of the private foundation are reduced by less than two percent by reason of changes in the number of outstanding shares.

Finally, the committee believes that three modifications to the rules governing pre-1969 holdings are appropriate. First, under the 1969 Act divestiture rules for grandfathered holdings, the 10-year and 15-year periods for the first phase are determined by reference to the combined holdings of the private foundation and disqualified persons, while the 20-year period is determined by reference only to the holdings of the private foundation. The committee does not find any reason for this different basis for measuring the length of the first phase. Accordingly, the bill provides that the 20-year period also is to be determined by reference to the combined holdings of the private foundation and disqualified persons.

Second, during the second and third phases of the divestiture rules for pre-1969 holdings, private foundations have a lower limit (i.e., 25 percent of voting stock) for direct holdings if disqualified persons own more than two percent of the business enterprise. Where disqualified persons first acquire more than two percent during those phases, the present statute does not permit any time for the private foundation to reduce its holdings to the lower limit and avoid excise taxes. Accordingly, the bill provides that in such circumstances, the private foundation has five years to reduce its holdings to the lower limit.

Finally, the committee bill makes a technical correction to the 1969 Act to allow the Herndon Foundation to continue to hold a majority interest in certain business holdings.

A number of concerns were brought to the attention of the committee relating to technical issues under certain provisions of the excess business holdings rules with respect to which final regulations have not yet been issued. It is the committee's understanding that final regulations relating to these reserved issues will provide that, except in certain abuse cases, there will be no constructive ownership through active business corporations, a passive parent corporation of an affiliated group of active business corporations will be treated as an active business corporation, stock received in a corporate reorganization or other readjustment will be treated as the stock surrendered in the reorganization or readjustment to the extent there is no increase in either the percentage ownership of the foundation or the percentage ownership of the foundation and its disqualified persons in combination, and any excess stock received in a corporate reorganization or other readjustment will be treated as acquired other than by purchase. Based on this understanding, the committee does not believe any statutory changes are required with respect to reserved issues under the excess business holdings regulations.

Explanation of Provisions

Disposition of certain post-1969 gifts or bequests

The bill gives the Internal Revenue Service discretionary authority to grant an extension of an additional five years to dispose of certain business holdings acquired by a private foundation after 1969 by gift or bequest. This provision applies only in the case of an unusually large gift or bequest of either diverse business holdings or holdings with complex corporate structures.

The extension will be available only if (1) prior to the close of the initial five-year period, the private foundation submits a plan to the Service for disposition of the business holdings, and (2) the Service determines that such plan can reasonably be expected to be carried out before the end of the extension period.[11] (Under a transitional rule, any plan for disposition submitted to the Service on or before the 60th day after the date of enactment of the bill is treated as if submitted before the close of the initial five-year period.) Before the Service can grant the extension, the foundation must establish that disposition within the initial five-year period was not possible (except at a price substantially below fair market value[12]) because of the size and complexity or diversity of the business holdings, and that the foundation has made diligent efforts to dispose of those business holdings within the initial five-year period.

This provision of the bill applies to business holdings as to which the initial five-year period (sec. 4943(c)(6)) ends on or after November 1, 1983.

Exception to downward ratchet rule

The bill provides an exception to the downward ratchet rule under which decreases in the percentage holdings of a private foundation are disregarded if (1) the decreases are due solely to the issuance of stock (or to issuance of stock coupled with subsequent redemptions of stock) of the business enterprise, (2) the net percentage decrease does not exceed two percent, and (3) the number of shares held by the private foundation is not affected by the issuance of stock or any redemption of stock which was coupled to the issuance of stock.[13]

If the exception applies, the limits on the maximum permitted holdings of the private foundation and on the maximum permitted combined foundation/disqualified person holdings will not be reduced by the amount of the net decrease. If the net percentage decrease exceeds two percent, the exception does not apply and, as under present law, the limit on the maximum holdings of the private foundation is permanently reduced by the amount of the decrease.

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[11] The plan must also be submitted to the Attorney General of the relevant State for his or her consideration, and the Internal Revenue Service is to consider any comments which the Attorney General may make as to the plan.

[12] For purposes of this provision in sec. 308 of the bill, a price which is at least five percent below fair market value is to be considered a price which is substantially below fair market value.

[13] For purposes of this provision in section 309 of the bill, an increase in the number of shares held by the foundation which results solely from a stock split applicable to all holders of the same class of stock is to be disregarded.

This amendment is effective for decreases and subsequent increases occurring after the date of enactment.

Eligibility for 20-year first phase

The bill modifies the divestiture rules of present law to provide that the 20-year first phase period to reduce pre-1969 excess business holdings applies if the combined holdings of the private foundation and disqualified persons exceeded 95 percent on May 26, 1969. This amendment is effective on the date of enactment.

Modification of second and third phases

The bill provides that if a private foundation's maximum business holdings must be reduced to 25 percent of the voting stock by reason of the acquisition by disqualified persons of more than two percent of the business enterprise during either the second or third phase of the divestiture rules, the private foundation is given five years to dispose of the excess over 25 percent. This five-year period cannot be extended pursuant to the provision of the bill (sec. 308) relating to the divestiture period for certain post-1969 gifts or bequests. This amendment applies to acquisitions made after the date of enactment.

Technical correction in description of Herndon Foundation

The bill makes a technical correction to clarify that the Herndon Foundation is permitted to continue to hold a majority of the stock of certain business enterprises. This amendment applies as if included in section 101(*l*)(4) of the Tax Reform Act of 1969.

J. Exemption for Certain Games of Chance (Sec. 312 of the bill and Code sec. 513)

Present Law

Under present law, organizations that are exempt from Federal income taxation are subject to tax on income derived from an unrelated trade or business (secs. 511-514). The term unrelated trade or business generally means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the activities for which the organization was granted tax exemption.

Present law includes an exception to the definition of an unrelated trade or business for certain bingo games conducted by tax-exempt organizations (sec. 513(f)).

Reasons for Change

The committee believes that, under certain circumstances, tax-exempt organizations should not be subject to the tax on unrelated business taxable income on income from games of chance which may legally be conducted under State law only by nonprofit organizations.

Explanation of Provision

The bill provides that the term unrelated trade or business does not include any trade or business that consists of conducting any game of chance if (1) the game of chance is conducted by a nonprofit organization, (2) the conducting of the game does not violate any State or local law, and (3) as of October 5, 1983, there was a State law in effect that permitted the conducting of the game of chance only by a nonprofit organization.

Effective Date

The provision applies retroactively to games of chance conducted after June 30, 1981, in taxable years ending after that date.

K. Exception to Self-Dealing Rules for Certain Stock Transactions (Sec. 313 of the bill and Code sec. 4941)

Present Law

The Tax Reform Act of 1969 in effect prohibited certain transactions between a private foundation and disqualified persons (including substantial contributors), and imposed excise taxes for violations of these rules. The transactions prohibited as "self-dealing" generally include (1) the sale, exchange, or leasing of property between a private foundation and a disqualified person and (2) the lending of money or other extension of credit between a private foundation and a disqualified person (sec. 4941).

Reasons for Change

Under present law, once a contributor to a foundation is treated as a substantial contributor, that person retains status as a disqualified person forever, regardless of the relative value of the person's contributions (sec. 507(d)). As indicated in the description below of section 314 of the bill, the committee believes that this rule should be changed so that the disqualified person status of a person whose relative contributions have become insignificant will terminate in appropriate cases.

In general, the committee believes that this change should apply prospectively. However, it has come to the attention of the committee that the rule that substantial contributors retain their status as disqualified persons forever has resulted in the application of the self-dealing rules in a case involving the sale of publicly traded stock of Murphy Motor Freight Lines, Inc. (the "Company") by the Wasie Foundation to the Company. In that case, the Company was treated as a disqualified person because of contributions of less than $10,000 early in the life of the Wasie Foundation. As a result, the sale of stock by the Wasie Foundation to the Company pursuant to the settlement of a court case involving the control of the Company was treated as an act of self-dealing. The committee believes that this transaction should not be subject to section 4941 taxes so long as the total consideration paid to the Wasie Foundation (i.e., the amount of any cash and the fair market value of any notes received for the stock by the Wasie Foundation in connection with such purchase) was equal to or exceeded the value of the stock at the time of the sale.

Explanation of Provision

The bill provides that Code section 4941 is not to apply to the purchase during 1978 of stock from a private foundation (and to any note issued in connection with such purchase) if (1) consideration for the purchase equaled or exceeded the fair market value of the stock; (2) the purchaser of the stock did not make any contribution to the foundation at any time during the five-year period ending on the date of the purchase; (3) the aggregate contributions to the foundation by the purchaser before such date were less than $10,000 and less than two percent of the total contributions received by the foundation as of that date; and (4) the purchase was pursuant to the settlement of litigation involving the purchaser. That is, under the bill Code section 4941 is not to apply in the case of the 1978 sale of stock of Murphy Motor Freight Lines, Inc. by the Wasie Foundation to Murphy Motor Freight Lines, Inc. and the related financing by the Wasie Foundation if the total consideration received (i.e., the sum of the cash and the value of the notes) equaled or exceeded the fair market value of the stock to Wasie Foundation.

Effective Date

The provision applies retroactively for 1978 and subsequent years. In addition, section 313 of the bill provides for a refund or credit of any section 4941 taxes previously paid if claim for refund or credit is filed within one year from the date of enactment.

L. Termination of Status as Substantial Contributor (Sec. 314 of the bill and Code sec. 507(d))

Present Law

Under present law, status as a disqualified person is relevant for several private foundation provisions, including the prohibitions on self-dealing between a disqualified person and the foundation and on excess business holdings. The term disqualified person generally includes substantial contributors, foundation officers, directors, or trustees, and members of the family of such an individual, plus certain other related entities (sec. 4946).

The term substantial contributor means a person whose contributions to the foundation exceeded two percent of all contributions received by the foundation before the close of the year in which the contribution is made, but only if the person's contributions exceed $5,000 (sec. 507(d)(2)). Once a person becomes a substantial contributor, that person retains that status forever.

Reasons for Change

The committee believes that the rule under which persons retain their status as substantial contributors forever is unnecessarily restrictive and may lead to unintended harsh consequences in certain circumstances. The committee believes that an individual may sufficiently terminate connection with and control over a private foundation, so that he or she no longer should be treated as a disqualified person, if there has been a sufficiently long time since that person had made any contribution to or had any relationship with the foundation, and if there have been much larger contributions from another person to the foundation. This often may be the case where a person makes relatively small contributions near the date of creation of the foundation and an unrelated person makes a substantially larger contribution later.

Explanation of Provision

The bill provides that a person will not continue to be treated as a substantial contributor as of the close of a taxable year of a foundation if three requirements are met.

First, neither the person nor any related person[14] made a contribution to the foundation at any time within the 10-year period ending at the close of the taxable year. Second, at no time during the 10-year period was that person or any related person a foundation manager of the private foundation. Third, the aggregate contributions (adjusted for the growth of the contributions in the foundation) made by such person and related persons are determined by the Internal Revenue Service to be insignificant when compared to the aggregate amount of contributions to that foundation by one other person. The committee intends that such contributions generally are to be considered insignificant if they are less than one percent of the contributions by the other person (adjusted for growth).[15]

Effective Date

The amendment made by section 314 applies to taxable years beginning after December 31, 1984.

M. Review of Treasury Regulations on Expenditure Responsibility (Code sec. 4945)

Present Law

In the case of grants to organizations other than public charities, a private foundation must exercise "expenditure responsibility" over the grant (sec. 4945(d)). To ensure that such grants will be properly used by the recipient for charitable purposes, the grantor must make reasonable efforts, and establish adequate procedures, to see that the grant is spent solely for proper uses, to obtain full reports from the grantee, and to make full reports to the Internal Revenue Service on the grants.

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[14] For purposes of this provision, the term related person means any other person who would be a disqualified person (within the meaning of sec. 4946) by reason of his or her relationship to the substantial contributor. In the case of a contributor which is a corporation, the term also includes any officer or director of the corporation.

[15] For example, a gift of $250,000 in cash in 1969 would be considered insignificant in comparison to a gift of $100 million made by another person in 1979. Similarly, a gift of $250,000 of stock in 1969 would be considered insignificant in comparison to a gift of $107 million in 1979, even assuming the value of the stock (originally worth $250,000 when made) had appreciated in value to $1.2 million as of the date on which the $107 million gift was made. However, a gift of $250,000 of stock in 1969 which had appreciated in value to $15 million would not be considered insignificant in comparison to another's gift of $107 million in 1979.

Treasury regulations expressly state that the expenditure responsibility rules do not make donor foundations insurers or guarantors of the activities of donee organizations, and set forth guidelines under which donor foundations may satisfy the section 4945 rules (Reg. sec. 53.4945-5(b)). For example, the regulations state that a private foundation considering a grant request should conduct a limited inquiry concerning the potential donee, complete enough to give a reasonable person assurance that the grant would be used for charitable purposes. The scope of the inquiry would vary with factors such as the dollar amount of the grant. No such pre-grant inquiry would be required if the donee organization had received prior grants from the donor foundation and had submitted to the donor the required reports substantiating proper use of the earlier grant funds.

The donor foundation must obtain a written commitment from the donee foundation that the latter will use the grant funds solely for charitable purposes and will submit reports as to whether the funds have been used in compliance with the grant terms. The grantor foundation need not conduct any independent verification of such reports unless it has reason to doubt their accuracy or reliability (Reg. sec. 53.4945-5(c)(1)). In meeting its own reporting requirements to the Internal Revenue Service, the grantor foundation may rely on statements from the donee organization or other records showing the information which the grantor, in turn, must report to the Service (Reg. sec. 53.4945-5(c)(4)).

Reasons for Committee Action

The committee reaffirms the central purpose of the expenditure responsibility rules—to ensure that foundation grants will be properly used by the recipient organization solely for exempt purposes. At the same time, the committee is concerned whether implementation of the statutory requirements in Treasury regulations may have added unduly burdensome or unnecessary requirements in some respects, which may operate to deter grants by some foundations to newly formed, community-based organizations.

Committee Action

The committee directed the Treasury Department to review its expenditure responsibility regulations for purposes of modifying requirements which are found to be unduly burdensome or unnecessary. As part of its review, Treasury is to modify the required grantor reports to the Internal Revenue Service. The Treasury Department is to report to the committee on its review and modifications.

N. Review of Treasury Regulations on Reliance on IRS Classifications

Present Law

Private foundations must exercise expenditure responsibility with respect to grants made to another private foundation (sec. 4945(d)). In addition, distributions to a private nonoperating foundation generally may not be used to satisfy the grantor foundation's minimum distribution requirements (sec. 4942). Therefore, in order to avoid violations of the expenditure responsibility and minimum distribution rules, a private foundation must determine whether a potential donee is a private foundation or public charity.

In many cases, the public charity status of a donee is determined by the percentage of its support that is received from the general public. The Internal Revenue Service issues determination letters to all section 501(c)(3) organizations relating to their status as public charities or private foundations. For new organizations without four years of support history, advance rulings are issued based on a determination of whether the charity can reasonably be expected to meet the public support test during an advance ruling period of either two or five years.

In general, a donor is permitted to rely on a determination by the Internal Revenue Service of a donee's public charity status until publication of notice of a change of status. However, a donor foundation may not rely on the donee organization's classification if the donor foundation is responsible for or aware of a "substantial and material" change in the donee organization's sources of support that results in the organization's loss of classification as a publicly supported organization. In general, the donor foundation will not be considered responsible for or aware of such a change in support (and hence may rely on a published classification) if the grant is made in reliance on a detailed written statement by the grantee organization that the grant will not result in loss of public charity status, and the information in such statement would not give rise to a reasonable doubt as to the effect of the grant (Treas. Reg. sec. 1.509(a)-(3)(c)).

To facilitate reliance on published classifications, the Internal Revenue Service has issued guidelines specifying circumstances under which a donor foundation will not be considered responsible for a "substantial and material" change in support of the donee organization.[16] In addition, the Service has published guidelines specifying circumstances under which a grant will be considered "unusual" and hence will not cause the donee organization to lose its status as publicly supported.[17]

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[16] Under these guidelines, a donor organization generally will not be considered responsible for a substantial and material change in support if the aggregate of gifts, grants, and contributions received from the donor organization for a taxable year does not exceed 25 percent of the aggregate support received by the donee organization from all other sources for the four taxable years immediately preceding the year of the grant (Rev. Proc. 81-6, 1981-1 C.B. 620). In such circumstances, the donor foundation can rely on the classification of the donee organization as publicly supported without risk that its grant will later be treated as causing the donee organization to lose its public charity status (thereby subjecting the donor foundation to excise tax penalties for failure to exercise expenditure responsibility).

[17] Under these guidelines, a grant generally will be considered unusual where six conditions are met: (1) the grant is not made by a donor foundation which created the donee organization

Continued

Reasons for Committee Action

While the committee believes that it is appropriate for a private foundation to inquire whether its grant will cause the donee to lose public charity status, the committee is concerned that private foundations may hesitate to make grants to new organizations that may have little support from the general public in the first two or three years of their existence, because it is difficult for the foundation to obtain assurance that the grant will not cause the organization to fail to qualify for public charity status.

Committee Action

The committee directed the Treasury Department to extend the advance ruling period during which qualifying new organizations are considered public charities to five years, and to amend its regulations to permit greater reliance on Internal Revenue Service classifications concerning new organizations in the first five years of their existence.

O. Revenue Effect

The provisions of title III of the bill will reduce fiscal year budget receipts by $13 million in 1984, $45 million in 1985, $46 million in 1986, $47 million in 1987, and $50 million in 1988.

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or was a substantial contributor to the donee organization; (2) the grant is not made by a donor organization which is in a position of authority to the donee organization; (3) the grant is made in cash, readily marketable securities, or assets that directly further the exempt purpose of the donee organization; (4) the donee organization has received an advance or final ruling that it is classified as a publicly supported organization; (5) there are no material restrictions imposed on the grant; and (6) if the grant is intended to pay for the operating expenses of the donee organization, the grant is expressly limited to one year's operating expenses (Rev. Proc. 81-7, 1981-1 C.B. 621).

TITLE IV—TAX SIMPLIFICATION PROVISIONS

A. Estimated Income Tax (secs. 411-414 of the bill, sec. 6654 of the Code, and Revenue Ruling 83-111)

Present Law

Under present law, an individual who fails to pay an installment of estimated income tax on or before the due date generally is subject to a penalty at the rate established for interest (under sec. 6621). The penalty may not be waived. The penalty is computed by applying the interest rate to the amount of the underpayment of the installment for the period of the underpayment. The amount of the underpayment is the difference between the payments (including withholding) made on or before the due date of each installment and 80 percent of the total tax shown on the return for the year, divided by the number of installments that should have been made. Estimated tax payments of the alternative minimum tax are not required.

There are four exceptions to the general underpayment penalty. No penalty is imposed upon a taxpayer if total tax payments for the year (withholding plus estimated tax payments) equal or exceed an installment based on (1) the preceding year's tax liability, if a return showing a liability for tax was filed for the preceding year; (2) 80 percent of the taxes which would be due if the income already received during the current year were placed on annual basis; (3) 90 percent of the tax which would be due on the income actually received from the beginning of the year to the computation date; or (4) the tax computed by using the facts shown on the prior year's return under the current year's tax rates and exemptions. Also, no penalty is imposed where the tax (reduced by withholding) is less than a minimal amount ($300 in 1983, $400 in 1984, and $500 in 1985 and thereafter), or where there was no tax liability for the preceding taxable year.

Reasons for Change

The committee believes that generally taxpayers who pay their tax by making estimated tax payments should, to the extent possible, be treated no more favorably than those who pay their tax primarily through wage withholding. While the present rules governing the estimated tax work well in most cases, there are technical problems and inequities that should be corrected. First, the committee is concerned that the Commissioner of Internal Revenue cannot waive the penalty for failure to make estimated tax payment even where the failure is due to extreme hardship. While the committee recognizes that the system cannot be administered if waivers are readily available, the Commissioner should have the authority to grant a waiver in limited extreme hardship cases.

Therefore, the bill authorizes the Internal Revenue Service to waive the penalty in certain limited circumstances.

In addition, the present law exceptions to the penalty may, on the one hand, allow individuals to improperly avoid estimated tax requirements in some circumstances, while subjecting other individuals to a substantial penalty for failure to meet one of the exceptions by a few dollars. The exceptions are therefore restructured to avoid these results. Finally, the committee believes that persons subject to the alternative minimum tax, as restructured under TEFRA, should be required to make current estimated payments just as individuals subject to other income taxes are required to do.

Explanation of Provision

Estimated income tax for individuals

The bill makes a number of modifications to the present law requirements and consolidates all the rules into one section of the Code. Under the bill, the underpayment penalty with respect to any installment will apply to the difference between payments made by the due date of the installment and the lesser of an installment based on 80 percent of the tax shown on the return or 100 percent of the tax shown on the preceding year's return, if a return was filed for the preceding year. In addition, a penalty will be imposed with respect to any payment only to the extent the total payments for the year up to the required installment are below 80 percent of the taxes which would be due if the income already received during the current year was placed on an annualized basis.[1] The exceptions from the penalty described in paragraphs (3) and (4) of present law (above) are repealed. Estimated tax payments for the alternative minimum tax will be required.

The Internal Revenue Service can waive the penalty if the failure to make a payment was due to casualty, disaster, or other unusual circumstances where it would be inequitable to impose the penalty. Thus, for example, this waiver could be granted where the taxpayer's books and records were destroyed by fire or other casualty, or where payment was not made because of the death or serious illness of the taxpayer. Also, the penalty can be waived where it would be inequitable to impose a penalty, for example, because the taxpayer substantially overstated his or her tax liability shown on the return.

Credit of tax overpayments

The bill also provides that the rules relating to the crediting of an income tax (individual or corporate) overpayment against an estimated tax liability shall be determined without regard to Revenue Ruling 83-111.[2] That ruling held that where a taxpayer with an overpayment of tax from a prior year files a timely return pursuant to an extension of time to file, the crediting of the overpayment to the current year's estimated tax liability may not be made prior to the date the return is filed and the taxpayer so elects.

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[1] Subsequent installments must be adjusted to recapture any reduction resulting from the application of this rule.

[2] I.R.B. 1983-31, p. 6.

Under the bill, it is intended that the taxpayer may elect to credit the overpayment to an estimated tax payment arising after the overpayment arose but before the election is made. Where the credit is made to an estimated tax payment arising prior to the election, interest on any overpayment will not be payable [3] and interest on any underpayment which arises because of a deficiency in tax for the prior year will run from the date the credit is effective.

Thus, for example, assume a taxpayer makes estimated tax payments (including withholding) of $10,000 in 1984 and receives an extension of time to file the 1984 return until August 15, 1985. Also assume that a return is filed on August 15, 1985, showing a liability of $8,000 for 1984. The taxpayer may elect to credit the $2,000 overpayment to the April 15 estimated tax payment of his or her 1985 tax. Interest on the $2,000 overpayment will not be payable. If it is later determined that the taxpayer's liability for 1984 was actually $11,000, interest on an underpayment of $3,000 will begin to run on April 15, 1985.

Effective Date

The provisions will generally be effective for taxable years beginning after December 31, 1984. The provision relating to Revenue Ruling 83-111 will be effective January 1, 1984.

Revenue Effect

The repeal of the "90 percent" and "this year's tax rates" exceptions from the penalty will increase revenues by $12 million in fiscal year 1985, by $11 million in fiscal year 1987, by $9 million in fiscal year 1988 and by $7 million in fiscal year 1989.

The provision measuring the penalty from last year's return will reduce revenues by $63 million in fiscal year 1986, by $69 million in fiscal year 1987, by $76 million in fiscal year 1988, and by $84 million in fiscal year 1989.

The provision allowing a waiver of the penalty will reduce revenues by less than $5 million a year beginning in fiscal year 1985.

The provision relating to the alternative minimum tax will increase revenue by $611 million in fiscal year 1985, $45 million in fiscal year 1986, $49 million in fiscal year 1987, $52 million in fiscal year 1988 and by $56 million in fiscal year 1989.

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[3] Treas. reg. section 301.6611-1(h)(2)(vii).

B. Domestic Relations

1. Treatment of Transfer of Property Between Spouses or Incident to Divorce (sec. 422 of the bill and sec. 1041 of the Code)

Present Law

The Supreme Court has ruled that a transfer of appreciated property to a spouse (or former spouse) in exchange for the release of marital claims results in the recognition of gain to the transferor *(United States* v. *Davis* (370 U.S. 65 (1962)). The spouse receiving the property receives a basis in the asset transferred equal to its fair market value. These rules do not apply in the case of the equal division of community property, and the IRS has ruled that this rule does not apply to the partition of jointly held property.[4] The tax treatment of divisions of property between spouses involving other various types of ownership under the different State laws is often unclear and has resulted in much litigation.[5] Several states have amended their property law in an attempt to avoid the result in the *Davis* case.

In addition, under present law, losses are not allowed with respect to the transfer of property between spouses (sec. 267), and capital gains treatment and installment sales reporting are not allowed on the sale or exchange of depreciable property between spouses (secs. 1239 and 453(g)). These limitations do not apply to transfers between former spouses.

Reasons for Change

The committee believes that, in general, it is inappropriate to tax transfers between spouses. This policy is already reflected in the Code rule that exempts marital gifts from the gift tax, and reflects the fact that a husband and wife are a single economic unit.

The current rules governing transfers of property between spouses or former spouses incident to divorce have not worked well and have led to much controversy and litigation. Often the rules have proved a trap for the unwary as, for example, where the parties view property acquired during marriage (even though held in one spouse's name) as jointly owned, only to find that the equal division of the property upon divorce triggers recognition of gain.

Furthermore, in divorce cases, the government often gets whipsawed. The transferor will not report any gain on the transfer, while the recipient spouse, when he or she sells, is entitled under the *Davis* rule to compute his or her gain or loss by reference to a basis equal to the fair market value of the property at the time received.

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[4] See Rev. Rul. 74-347, 1974-2 C.B.26

[5] See e.g., *Commissioner* v. *Collins*, 412 F.2d 211 (10th Cir. 1969) *U.S.* v. *Wallace*, 439 F. 2d 757 (8th Cir. 1971); *Commissioner* v. *Wiles*, 499 F.2d 255 (10th Cir. 1974); *U.S.* v. *Imel*, 523 F.2d 853 (10th Cir. 1975); *W. W. McKinney*, 64 T.C. 262 (1975); *U.S.* v. *Bosch*, 590 F.2d 165 (5th Cir. 1979).

The committee believes that to correct these problems, and make the tax laws as unintrusive as possible with respect to relations between spouses, the tax laws governing transfers between spouses and former spouses should be changed.

Explanation of Provision

The bill provides that the transfer of property to a spouse incident to a divorce[6] will be treated, for income tax purposes, in the same manner as a gift. Gain (including recapture income) or loss will not be recognized to the transferor, and the transferee will receive the property at the transferor's basis (whether the property has appreciated or depreciated in value). A transfer will be treated as incident to a divorce if the transfer occurs within one year after the parties cease to be married or is related to the divorce. This nonrecognition rule applies whether the transfer is for the relinquishment of marital rights, for cash or other property, for the assumption of liabilities in excess of basis, or for other consideration and is intended to apply to any indebtedness which is discharged. Thus, uniform Federal income tax consequences will apply to these transfers notwithstanding that the property may be subject to differing state property laws.

In addition, this nonrecognition rule applies in the case of transfers of property between spouses during marriage.

Where an annuity is transferred, or a beneficial interest in a trust is transferred or created, incident to divorce or separation, the transferee will be entitled to the usual annuity treatment, including recovery of the transferor's investment in the contract (under sec. 72), or the usual treatment as the beneficiary of a trust (by reason of sec. 682), notwithstanding that the annuity payments or payments by the trust qualify as alimony or otherwise discharge a support obligation.[7] The transfer of a life insurance contract to a spouse incident to a divorce or separation generally will no longer result in the proceeds of the policy later being includible in income, since the policy will have a carryover basis and therefore the transfer for value rules (sec. 101(a)(2)) will not apply. Also, the transfer of an installment obligation will not trigger gain and the transfer of investment credit property will not result in recapture if the property continues to be used in the trade or business.

Effective Date

The provision applies (1) to transfers after the date of enactment of the bill, and (2) to transfers after December 31, 1983, and on or before the date of enactment of the bill if both parties elect. However, it will not apply to transfers after the date of enactment pursuant to instruments in effect before that date unless both parties elect to have the provision apply.

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[6] For purposes of this provisions, an annullment is treated as a divorce.

[7] This rule relates, in part, to amendments made to Code section 71 by section 423 of the bill.

Revenue Effect

This provision will reduce revenues by less than $5 million annually.

2. Alimony (sec. 423 of the bill and secs. 71 and 215 of the Code)

Present Law

In general

Under present law, payments of alimony pursuant to a decree of divorce or separate maintenance, a written separation agreement or decree for support or maintenance are deductible by the payor spouse and includible in the income of the recipient spouse. The amount of the payment is deductible in computing adjusted gross income and thus is allowable whether or not the payor itemizes his or her deductions.

In order to be treated as alimony, a payment must meet several requirements. First, the payment must be in discharge of a legal obligation imposed upon or incurred by a spouse because of a family or marital relationship. Second, the payment must be imposed under the decree of divorce or separate maintenance or under a written instrument incident to the divorce or separation, made under a written separation agreement, or required under a decree of support or maintenance. Third, the payment must be "periodic." A payment will not qualify as "periodic" if it discharges a principal sum, unless the sum may be paid over a period exceeding 10 years from the date of the divorce or separation decree, instrument or agreement; then the annual amount treated as alimony cannot exceed 10 percent of the principal sum. A contingent payment is not a payment in discharge of a principal sum.

Payments which are fixed by the decree or agreement as child support are not treated as alimony and therefore are not deductible by the payor or includible in income of the recipient.[8]

Legislative background

Prior to 1942, there was no statutory provision explicitly dealing with alimony payments. In 1917, the Supreme Court held that, under the provisions of the Income Tax Act of 1913, alimony paid to a divorced wife was not taxable income.[9] From 1917 to 1942, the result in the *Gould* case remained unchanged and alimony was neither includible in the recipient's income nor deductible by the payor.

When tax rates were increased significantly in 1942, Congress recognized that the higher tax rates would intensify the hardship of payment of alimony out of after-tax income. Congress, therefore, enacted provisions in the Revenue Act of 1942 to require that certain alimony payments be included in the recipient spouse's income and to permit the payor spouse to deduct those payments as an itemized deduction. These provisions applied to alimony payments made by persons who were divorced or legally separated. In 1954, the alimony provisions were extended to apply to payments made under a decree for support where the parties are physically separated. The Tax Reform Act of 1976 permitted alimony to be deducted in arriving at adjusted gross income so that a taxpayer who does not itemize deductions may nevertheless deduct alimony.

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[8] *Commissioner* v. *Lester*, 366 U.S. 299 (1961) sets forth rules relating to the designation of amounts as child support rather than alimony.

[9] *Gould* v. *Gould*, 245 U.S. 151 (1917).

Tax effects

A principal purpose for the present tax treatment of alimony is to relieve the payor of the burden of paying tax on the income which is transferred to the payee spouse as alimony and to impose that burden on the spouse receiving the alimony. In addition to transferring the tax burden, under present law an overall tax savings generally results because the payor is normally in a higher marginal tax bracket than the payee. Because rates for a single taxpayer or head of household are lower than the rates for married persons filing separate returns (upon which the joint return rates are based), two individuals who are divorced and between whom alimony is paid may pay less total tax than they paid prior to marriage or during marriage.

For example, assume that single individuals A and B have earned income of $51,000 and $11,000 (taxable income of $50,000 and $10,000), respectively. As single taxpayers, their respective taxes for 1983 would be $14,738 and $1,121. Their combined tax is $15,859. If A and B were married for 1983, their joint return tax liability would be $15,574.[10] If A and B are divorced for 1983 and A pays B $20,000 alimony, they each would have a liability as a single taxpayer of $6,477. Their combined tax would be $12,954.

Reasons for Change

The committee believes that the present law definition of alimony is not sufficiently objective. Differences in State laws create differences in Federal tax consequences and administrative difficulties for the IRS. The committee believes that a uniform Federal standard should be set forth to determine what constitutes alimony for Federal tax purposes. This will make it easier for the Internal Revenue Service, the parties to a divorce, and the courts to apply the rules to the facts in any particular case and should lead to less litigation. The committee bill attempts to define alimony in a way that would conform to general notions of what type of payments constitute alimony as distinguished from property settlements and to prevent the deduction of large, one-time lump-sum property settlements.

Explanation of Provision

Under the bill, alimony payments will continue to be deductible by the payor spouse and includible in income by the recipient spouse.[11] However, the bill amends the definition of alimony. The requirement that the payment must be made on account of a marital obligation imposed under local law will be repealed and the present law requirement that the payment be "periodic" will not be retained.

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[10] This is based on $58,900 taxable income ($62,000 gross income, $1,100 marriage penalty deduction (under sec. 221) and a $2,000 deduction for personal exemptions. This example assumes neither party itemizes deductions.

[11] The bill does not affect the present law rules concerning the ability of a deceased spouse's estate to deduct alimony payments.

Under the bill, an alimony payment must meet several requirements. The payment must be made in cash and be received by, or on behalf of, the payee spouse (or former spouse). A payment can also qualify as alimony, for example, where a cash payment is made to a third party for the benefit of the payee spouse. As under present law, an alimony payment must be made under a decree of divorce or separate maintenance or under a written instrument incident to the divorce, a written separation agreement, or a decree requiring support or maintenance payments.

Where the parties are divorced or legally separated, they may not be members of the same household at the time the payment is made. The parties are not to be treated as members of the same household where the taxpayer is preparing to shortly depart from the household of the other spouse.

In order to prevent the deduction of amounts which are in effect transfers of property unrelated to the support needs of the recipient, the bill provides that a payment qualifies as alimony only if the payor (or any person making a payment on behalf of the payor) has no liability to make any such payment for any period following the death of the payee spouse. A provision for a substitute payment, such as an additional amount to be paid as child support after the death of the payee spouse will prevent a corresponding amount of the payment to the payee spouse from qualifying as alimony. Amounts payable under a life insurance contract on the life of the payee spouse will not be treated as a liability which would affect the status of other payments made by the payor spouse.

The parties, by clearly designating in a written agreement, can provide that otherwise qualifying payments will not be treated as alimony for Federal income tax purposes and therefore will not be deductible or includible in income.

As under present law, amounts fixed as child support will not be treated as alimony.

The bill provides that the Internal Revenue Service may require the payor spouse to furnish on his or her tax return the name and social security number of the payee spouse, and that the payee must furnish that number to the payor. A $50 penalty can be assessed against any party for failure to comply with the applicable requirement.

In order to prevent a one-time property settlement from being disguised as alimony, the bill provides for the recapture of excess amounts which have been treated as alimony during the calendar year the payments began or the next succeeding calendar year. Under these rules if the alimony payments in the first year exceed the average payments in the second and third year by more than $15,000, the excess amounts are recaptured in the third year by requiring the payor to include the excess in income and allowing the payee who previously included the alimony in income a deduction for that amount in computing adjusted gross income. A similar rule applies to the extent the payments in the second year exceed the payments in the third year by more than $15,000. This rule is intended to prevent persons whose divorce occurs near the end of the year from making a deductible property settlement at the beginning of the next year. Recapture is not required if either party dies or if the payee spouse remarries by the end of the calendar year which is two years after the payments began and payments ceases by reason of that event. Also the rule does not apply to temporary support payments (described in sec. 71(b)(2)(C)) or to payments which fluctuate as a result of a continuing liability to pay, for at least three years, a fixed portion of income from the earnings of a business, property or services.

Thus, for example, if the payor makes alimony payments of $50,000 in the first year and no payments in the second or third year, $35,000 will be recaptured (assuming none of the exceptions apply). If instead the payments are $50,000 in the first year, $20,000 in the second year and nothing in the third year, the recapture amount will consist of $5,000 from the second year (the excess over $15,000) plus $27,500 for the first year (the excess of $50,000 over the sum of $15,000 plus $7,500). (The $7,500 is the average payments for years two and three after reducing the payments by the $5,000 recaptured from year two.)

Effective Date

These provisions will generally apply to divorce or support decrees and agreements executed after 1984. The provision will also apply with respect to the modification of a prior instrument where the modified instrument expressly so provides.

Revenue Effect

These provisions will reduce revenues by $8 million in fiscal year 1985, $49 million in fiscal year 1986, and $12 million in fiscal year 1987, and will increase revenues by $25 million in fiscal year 1988 and $41 million in fiscal year 1989.

3. Dependency Exemption (secs. 424 and 427 of the bill and secs. 151 and 152(e) of the Code)

Present Law

Under present law, a $1,000 deduction, for a dependency exemption, is generally allowed for each dependent child of the taxpayer. Normally, in order to qualify as a taxpayer's dependent, a child must have over half of his or her support for the year furnished by the taxpayer. The child may not have gross income of $1,000 or more in the taxable year unless the child is under the age of 19 or is a student.

In the case of children of divorced or separated parents, a special rule applies in determining which parent provided over half of the support (sec. 152(e)).

In general, a divorced or separated parent who has custody of a child for the greater part of the year (the custodial parent) may claim the dependency exemption for the child if the parents together have custody of the child for more than one-half of the year and provide more than one-half of the child's support. A special rule provides that the noncustodial parent, rather than the custodial parent, may claim the dependency exemption if (1) a decree or written agreement allocates the exemption to the noncustodial parent and the noncustodial parent pays at least $600 for the support of the child during the calendar year; or (2) the noncustodial parent provides at least $1,200 for the support of the child during the calendar year and the custodial parent does not clearly establish that he or she provided more for the support of the child than did the noncustodial parent. None of these rules apply in the case where the dependency exemption has been allocated under the special rules applying to multiple support where no one person contributed over half the support of an individual.

In addition to the dependency exemption, the deduction for medical expenses, the treatment of a parent as qualifying for either single rates or head of household rates, the earned income credit, and the credit for household and dependent care services are, in part, determined by reference to whether the parent furnishes over half of the support of a child.

Reasons for Change

The present rules governing the allocations of the dependency exemption are often subjective and present difficult problems of proof and substantiation. The Internal Revenue Service becomes involved in many disputes between parents who both claim the dependency exemption based on providing support over the applicable thresholds. The cost to the parties and the Government to resolve these disputes is relatively high and the Government generally has little tax revenue at stake in the outcome. The committee wishes to provide more certainty by allowing the custodial spouse the exemption unless that spouse waives his or her right to claim the exemption. Thus, dependency disputes between parents will be resolved without the involvement of the Internal Revenue Service.

Explanation of Provision

Under the bill, as under present law, the parent having custody of a child for the greater portion of the year (the custodial parent) will generally be treated as having provided more than one-half of the child's support and therefore be entitled to the dependency exemption. This rule also will apply to parents not living together during the last 6 months of the calendar year, as well as those divorced or separated under a separation agreement. The bill provides three exceptions to the general rule. First, the custodial parent can release his or her claim to the exemption for the year to the noncustodial parent. For this exception to apply, the custodial parent will have to sign a written declaration that he or she will not claim the child as a dependent for the year, and the noncustodial parent will have to attach the written declaration to his or her tax return. That declaration may be made for one or more specified calendar years. The parties may make a permanent declaration a copy of which the noncustodial parent attaches to each year's return, or the declaration may be made by the custodial spouse annually in order to better insure the receipt of child support payments.

Next, as under present law, the general rule will not apply in the case of multiple support agreements. Finally, an exception is provided to continue existing law for certain decrees or agreements which are executed before January 1, 1985, and under which the custodial parent had agreed to release his or her claim to the dependency exemption to the noncustodial parent . Thus, if such an agreement exists, the noncustodial parent may claim the dependency exemption if he or she provides at least $600 for the support of the child during the year. The parties may modify the decree or agreement to make this rule inapplicable by expressly so providing.

The bill also provides that the support by the spouse of a remarried parent will be treated as support provided by that parent in applying these rules.

For purposes of the medical expense deduction, any child subject to the rules described above will be treated as a dependent of both parents. Thus, a parent can deduct medical expenses paid by that parent for the child even though a dependency exemption for the child may be allowed to the other parent.

Under the bill, certain provisions are amended to provide consistent rules among various inter-related sections concerning family status of individuals living apart. The basic rule adopted is that in the present child and dependent care credit (sec. 44A)). An amendment is made to section 143(b) to provide that for an otherwise married individual living with a child to be considered not married, his spouse may not be a member of the household for the last six months of the year, rather than the entire year as under present law. The definition of head of household status (sec. 2) is amended to provide that the household must be maintained as the principal place of abode for the child for more than one-half of the year, rather than for the entire year as under present law. Further, the definitions of marital and head of household status, the earned income credit (sec. 43), and the child and dependent care credit (sec. 44A) are amended to provide that any custodial parent who releases a claim to a dependency exemption under the above rules will be treated as entitled to the dependency exemption for the purposes of these sections. Thus, such a custodial parent could be eligible for unmarried status, head of household status, or the credits if the other conditions of those provisions are met.

Finally, the bill provides that the $1,000 dependency exemption is to be determined without regard to any income received by an individual who is permanently and totally disabled for services performed at a sheltered workshop school operated by a charity or government.

Effective Date

These provisions will be effective for taxable years beginning after December 31, 1984.

Revenue Effect

These provisions will have a negligible revenue effect.

4. Innocent Spouse Relieved of Liability in Certain Cases (sec. 425 of the bill and secs. 66 and 6013 of the Code)

Present Law

Tax liability of spouses who file joint returns

In general, a husband and wife are permitted to file a joint income tax return, even if one spouse has no income or deductions. Spouses who file a joint return have joint and several liability for the tax computed on their aggregate income.

Under limited circumstances, a spouse may be relieved of liability for tax (including interest and penalties) on a joint return (sec. 6013(e)). The application of this so-called innocent spouse rule is limited to cases in which the liability for tax results from an omission from gross income that exceeds 25 percent of the gross income stated in the return. In such cases, the person seeking relief must establish that the unreported income is attributable to the other spouse, and that he or she had no knowledge of (or reason to know of) the omission. The determination of the spouse to whom the unreported income is attributable is made without regard to community property laws. In addition, taking into account whether the innocent spouse significantly benefitted from the omission from income, a determination is required as to whether it would be inequitable to hold such spouse liable for the tax. In determining whether there was an omission of more than 25 percent of the income disclosed on the return, amounts as to which adequate information was provided on the return are not taken into account.

Community income of spouses who live apart

In general, if a husband and wife file separate returns, each is required to report one-half of the income attributable to community property under State law. However, if certain requirements are met, relief from tax liability is provided for an abandoned spouse (sec. 66). To qualify, a couple must be married at some time during the calendar year, but live apart during the entire calendar year. The spouse seeking relief must not have filed a joint return, and one or both of the spouses must have earned income (*i.e.*, income attributable to the performance of personal services) that constitutes community income. In addition, no portion of the earned income (other than *de minimis* amounts) may have been transferred (directly or indirectly) between the spouses before the close of the calendar year.

If all of the above requirements are met, the applicable community property law with respect to certain types of income will be disregarded for Federal income tax purposes. Under special allocation rules (1) earned income (other than income from a trade or business or a partner's distributive share of a partnership's income) is treated as the income of the spouse who rendered the personal services, (2) income derived from a trade or business (other than that carried on by a partnership) is treated as the income of the spouse who carries on the trade or business, unless the other spouse exercises substantially all of the management and control of such trade or business, and (3) a partner's distributive share of a partnership's income is treated as the income of the partner. All other community income is characterized in accordance with the applicable community property laws.

Reasons for Change

The committee believes that the present law rules relieving innocent spouses from liability for tax on a joint return are not sufficiently broad to encompass many cases where the innocent spouse deserves relief. Relief may be desirable, for example, where one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony and may be unaware that there are untaxed profits from the business which the other spouse has squandered.

Also there may be situations in community property states when it is inequitable to tax a spouse filing a separate return on earnings of the other spouse where the innocent spouse received no benefit from the earnings.

Explanation of Provision

Overview

The bill liberalizes the innocent spouse joint return relief provision by expanding the circumstances in which the relief may be granted. The bill also provides additional relief to a spouse who is liable for tax on community income that is attributable to the other spouse.

Joint return liability of innocent spouse

Under the bill, the innocent spouse (sec. 6013(e)) rule will apply to cases in which the tax liability results from a substantial understatement of tax that is attributable to grossly erroneous items (including claims for deductions or credits, as well as omitted income) of the other spouse. Grossly erroneous items include any item of income that is omitted from gross income, regardless of the basis for omission. A claim for deduction or credit will be treated as a grossly erroneous item only if the claim had no basis in law or fact. The bill defines a substantial understatement as any understatement of tax that exceeds $500. As under present law, relief may be granted only where it would be inequitable to hold the innocent spouse liable.

In applying these rules, community property laws will continue to be disregarded in determining to whom an item is attributable. The bill does not specifically require that the determination of whether it would be inequitable to hold the innocent spouse liable include the consideration of whether such spouse benefitted from the erroneous item, but that factor should continue to be taken into account. The omission from income determination may apply notwithstanding that adequate information about the erroneous items was provided on the return.

Relief for separate return liability attributable to community income

The bill provides a new rule relating to the treatment of certain community income. This provision applies in cases where a spouse fails to include in gross income an item of community income that would be treated as the income of the other spouse if the special allocation rules applicable under the community-income provision of present law had applied. This rule will apply only where the spouse seeking relief does not file a joint return for the taxable year, and establishes that, at the time the return was filed (if a return is filed), he or she had no knowledge of (or reason to know of) the item of community income. The bill also requires that a determination be made that it would be inequitable to include the unreported income in the gross income of the spouse seeking relief. This determination may take into account whether the spouse benefitted from the untaxed income and whether the defense was promptly raised so as to prevent the period of limitations from running on the other spouse.

If all of the above requirements are met, then the unreported community income will be included in the gross income of the spouse to whom the income is attributable under the special rules of allocation.

Effective Date

The bill will apply to all taxable years to which the Internal Revenue Code of 1954 applies. Further, the bill provides that corresponding provisions will be deemed to be included in the Internal Revenue Code of 1939, and will apply to all taxable years to which the 1939 Code applied. The effective date provided in the bill is not intended to open a year that has been closed by the statute of limitations, res judicata, or otherwise.

Revenue Effect

This provision will have a negligible revenue effect.

5. Gift and Estate Tax Treatment of Certain Property Settlements (sec. 426 of the bill and secs. 2043 and 2516 of the Code)

Present Law

Under present law, transfers of property (other than certain terminable interests) between spouses are not subject to estate or gift taxes.

With several exceptions, transfers of property to a former spouse in satisfaction of marital or property rights are taxable gifts. A transfer of property between former spouses is not subject to gift tax if the transfer is pursuant to a written agreement entered into not more than two years prior to divorce and is in settlement of marital or property rights or to provide a reasonable allowance for the support of minor children (sec. 2516). In addition, property transfers ordered by a divorce court having the power to order the disposition of the property are not taxable gifts.[12] Finally, the transfer of property in discharge of a former spouse's right to support is not a taxable gift.

For estate tax purposes, a claim of a former spouse based on the release of marital or property rights is not deductible in computing the taxable estate unless the claim is based on a court decree where the court had the power to determine the marital or property rights of the spouse.[13]

Reasons for Change

The committee believes that the estate tax treatment of transfers made in settlement of marital or property rights should be conformed to the gift tax treatment. This will allow the parties to rely on a written agreement even though the payor spouse dies before the agreement is completely executed. The committee also believes the parties should have additional time to enter into the written agreement.

Explanation of Provision

The bill allows an estate tax deduction for transfers pursuant to claims arising under a written agreement in settlement of marital or property rights where the agreement would have qualified those transfers as non-taxable for gift tax purposes (under sec. 2516). Thus, where the transferor dies prior to completing the transfers under the written agreement, no estate tax will be imposed with respect to the property transferred by the estate.

The bill also allows the parties one year after the divorce to enter into the written agreement.

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[12] *Harris* v. *Comm'r.*, 340 U.S. 106 (1950).

[13] Id.

Effective Date

This provision will apply in the case of decedents dying after the date of enactment of the bill and to lifetime transfer after that date.

Revenue Effect

This provision will have a negligible revenue effect.

C. Revision of At-Risk Rules (Secs. 431 and 432 of the bill and secs. 46, 48 and 465 of the Code)

Present Law

Loss limitation rules

Present law (sec. 465) provides an at-risk limitation on losses from business and income-producing activities other than real estate and certain corporate leasing transactions.[14] The rule is designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in an activity.

Under the loss limitation at-risk rules, a taxpayer's deductible losses from an activity for any taxable year are limited to the amount the taxpayer has placed at risk (i.e., the amount the taxpayer could actually lose) in the activity. The initial amount at risk is generally the sum of (1) the taxpayer's cash contributions to the activity, (2) the adjusted basis of other property contributed to the activity, and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has pledged security for repayment. This amount is generally increased by the taxpayer's share of income and is decreased by the taxpayer's share of losses and withdrawals from the activity.

A taxpayer is generally not considered at risk with respect to borrowed amounts if (1) the taxpayer is not personally liable for repayment of the debt (nonrecourse loans), (2) the lender has an interest (other than as a creditor) in the activity, or (3) the lender is a related party to the taxpayer. In the case of activities other than investments in motion picture films or video tapes, farms, oil and gas property, geothermal property, or leased personal property (generally, the areas covered by the original 1976 at-risk rules), the interested party and related party rules apply only to the extent established by Treasury regulations. The taxpayer is also not considered at risk with respect to amounts for which the taxpayer is protected against loss by guarantees, stop-loss arrangements, insurance (other than casualty insurance) or similar arrangments. Losses which may not be deducted for any taxable year because of the loss limitation at-risk rule may be deducted in any subsequent year in which the rule does not prevent the deduction.

The loss limitation at-risk rule is applicable to individuals and to closely held corporations more than 50 percent of the stock in which was owned, at any time during the last half of the taxable year, by or for 5 or fewer individuals.[15] Stock ownership is generally determined according to the rules applicable for purposes of identifying a personal holding company (sec. 542(a)(2)). In the case of a partnership or S corporation, the rules apply at the partner or shareholder level.[16]

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[14] The Tax Reform Act of 1976, P.L. 94-455, applied the at-risk rule to four specific activities: (1) holding, producing, or distributing motion picture films or video tapes; (2) farming; (3) leasing of personal property; and (4) exploring for, or exploiting, oil and natural gas resources. The Revenue Act of 1978, P.L. 95-600, extended the rule to all activities except real estate and certain equipment leasing engaged in by closely held corporations.

[15] The at-risk rule was extended to closely held corporations in 1978.

The loss limitation at-risk rules are applied on an activity-wide basis. Present law provides that a taxpayer's activity with respect to any individual film, farm, oil and gas property, geothermal property, or leased personal property is treated as a separate activity. Thus, a taxpayer may deduct losses from an oil and gas property, for example, only to the extent he is at risk with respect to that specific property.[17] With respect to other types of investment, activities are treated as one activity (i.e., aggregated) if the activities constitute a trade or business and the taxpayer actively participates in the management of that trade or business (in the case of partnerships or S corporations, if 65 percent or more of losses is allocable to persons who actively participate in the management of the trade or business). A taxpayer may thus deduct losses from these activities based on the extent of his at-risk investment in an entire actively managed trade or business.

Investment tax credit rules

The Economic Recovery Tax Act of 1981 provided that the allowance of the investment tax credit is subject to an at-risk limitation. The limitation applies to the same activities and the same category of taxpayers that are subject to the at-risk loss limitation rules. Thus, the investment credit at-risk rules applies to individuals and closely held corporations that are engaged in a trade or business or other income-producing activity (other than real estate and certain corporate leasing).

Under the investment tax credit at-risk rules, the credit is not allowed for amounts invested in qualifying property to the extent the invested amounts are not at risk within the meaning of the loss limitation provisions (sec. 465(b)). Amounts generally are not considered at risk if (1) the amount was borrowed and the taxpayer is not personally liable for repayment of the debt (nonrecourse debt), (2) the lender has an interest (other than a creditor) in the business activity in which the property is used, (3) the lender is a related party to the taxpayer, or (4) the taxpayer is protected against the loss of the invested amount.

Present law provides two exceptions to the investment credit at-risk rules. Under the first exception, amounts borrowed (other than convertible debt) with respect to qualifying investment tax credit property no later than the taxable year the property is placed in service are generally considered at risk if (1) the taxpayer at all times has a minimum 20-percent at-risk investment in the property (determined without regard to the exception) and (2) the amount borrowed is owed to either a qualified lender or a Federal, State, or local government, or is guaranteed by a Federal, State or local government. Qualified lenders include banks, savings and loan institutions, credit unions, insurance companies, qualified pension trusts, and other persons actively and regularly engaged in the business of lending money.

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[16] These provisions no longer apply at the corporate level as a result of an amendment made by the Subchapter S Revision Act of 1982 (P.L. 97-354).

[17] Present law allows aggregation, under certain conditions, of films, farms, and leasing and oil and gas properties owned by a partnership or S corporation.

For the qualified lender exception to apply, the lender must not be related to the taxpayer. The qualified lender may also not be a person who receives a fee with respect to the taxpayer's investment in the qualifying property (e.g., a promoter) or a person related to such person. The exception also does not apply if the taxpayer has acquired the property from (1) the qualified lender (or a person related to the lender) or (2) a person related to the taxpayer.

Present law also applies a safe harbor exception for certain level payment loans related to qualified energy property.

In the case of a partnership or S corporation, the investment credit at-risk rule applies at the partner or shareholder level. Thus, the calculation of amounts at-risk is made by each partner or shareholder to whom the at-risk rules apply. Amounts for which a partnership or S corporation are considered at risk under the qualified lender exception are allocated among the partners or shareholders according to the rules for allocation of the investment tax credit. However, this allocation rule does not apply for purposes of determining whether each partner or shareholder has a minimum 20-percent at-risk investment in the property. Thus, to benefit from the qualified lender exception, each partner or shareholder must have an individual 20-percent at-risk investment in the property, determined under the general rule (i.e., the partner or shareholder must contribute cash or be personally liable for borrowed funds in this amount).

The at-risk limitation on the investment tax credit applies to property placed in service on or after February 19, 1981. An exception is provided for property placed in service on or after that date if the property was acquired by the taxpayer under a binding contract entered into before February 19, 1981.

Credit pass-through leases

Present law (sec. 48(d)) allows a lessor of new investment tax credit property to elect to transfer ("pass through") the credit to the lessee, subject to certain conditions. For certain short-term leases, only a portion of the credit may be transferred.

The present law at-risk rules do not specifically indicate how the rules apply in the case of a pass-through lease. Some lessees have apparently taken the position that the rules do not apply to a lessee, thus effectively rendering the rules inapplicable to certain lease transactions. These lessees appear to have claimed the credit although the lessee (and in some cases, the lessor) has little or no at-risk investment in the property.

Legislative background

The loss limitation at-risk rule was first adopted by Congress in 1976, and later expanded in 1978, in order to limit the incentives for taxpayers to reduce their tax liability by investing in tax shelter activities in which they were not subject to real economic risk. The investment tax credit at-risk rule was adopted for similar reasons in 1981.

In general, the at-risk rules limit a taxpayer's tax benefits from an activity to those benefits attributable to funds which the taxpayer has personally invested in an activity (in the case of the loss limitation rule) or a property (in the case of the investment tax credit rule), including funds which the taxpayer borrowed and is personally liable to repay. In the case of property which is seller-financed (or financed by a party related to the seller), this reduces the incentive for the parties to inflate the purchase price in order to give the purchaser additional tax deductions (for depreciation or accrued interest) or an inflated investment tax credit. In these situations, the buyer may otherwise be unconcerned about the higher price, since the property may simply be repossessed by the seller after the buyer has benefited from the inflated deductions or credits. The at-risk rules also prevent tax benefits from accruing to a purchaser who has no real equity in a property because the property's value is, or may become, less than the face amount of a nonrecourse loan on the property. In these situations, the purchaser may be receiving tax benefits without bearing the economic burden of any corresponding decline in the property's value. In addition, the at-risk rules reduce the situations in which taxpayers may fail to "recapture" income or credits from the disposition of tax shelter property since, under the at-risk rules, the deductions would not originally have been allowed.

Reasons for Change

The committee is concerned that the investment tax credit at-risk rules contained in ERTA have generated significant confusion among taxpayers and inhibited certain non-tax shelter transactions. It appears that the interdependence of the loss limitation at-risk rules (which are applied on an activity-wide basis) and the investment tax credit rule (which must be applied on a property-by-property basis) is largely responsible for this confusion. By fashioning an independent rule for the investment tax credit, and adjusting the application of the qualified lender rule, the committee believes it has created a workable and fair new provision. In order to avoid any inequities which may result from application of the ERTA rules, the committee has made the new provisions applicable (at the taxpayer's election) as if included in ERTA.

With regard to the pass-through of the investment tax credit to a lessee, the committee is concerned that taxpayers have taken positions effectively avoiding the application of the at-risk rules to tax shelter lease transactions. To prevent persons from taking these positions, the bill specifically applies the at-risk rule to the lessee based on the minimum rent for which the lessee is personally liable under the lease. This is consistent with the general principle that a credit (or deduction) should be allowed only where a taxpayer bears a real economic risk.

The committee believes that the at-risk rules generally (including the loss limitation and investment tax credit at-risk rules) should continue to apply in those situations where tax shelter possibilities (i.e., overvaluation of assets or transfer of tax benefits to a party with no real equity in the property) present themselves. However, where non-recourse financing constitutes bona fide financing in which the debtor has a real equity interest in the property and is likely to make all payments for the property, and where repossession is unlikely, these tax shelter elements are not present and the at-risk rules are not needed. The bill identifies these situations by excluding from the at-risk rules active closely held corporate businesses, subject to certain minimum activity requirements. This change will eliminate the competitive disadvantage encountered by certain closely held businesses which have been prevented from utilitizing legitimate nonrecourse financing (or recourse financing by active subsidiaries) by the at-risk rules.

In addition to the changes above, the committee's bill makes certain adjustments regarding the aggregation of activities for at-risk purposes and borrowing from related parties, consistent with the underlying policy of the at-risk rules.

Explanation of Provision

Revision of investment tax credit at-risk rules

Under the bill, the investment tax credit at-risk rules are revised. Instead of applying the loss limitation (sec. 465) at-risk rules directly, the bill reduces the credit base for the investment tax credit by the amount of nonrecourse financing, other than certain commercial financing, with respect to a property. However, the general concepts of the at-risk rules will continue to apply.

Under the bill, the basis (or cost, in the case of used property) of property for purposes of determining the investment tax credit is to be reduced by the amount of nonrecourse financing (other than qualified commercial financing) with respect to the property. The provision applies to the same taxpayers and the same activities that are currently subject to the at-risk rules. Nonrecourse financing includes amounts with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar agreements. Except to the extent otherwise provided by regulations, nonrecourse financing also includes amounts borrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used or a person related to such person (other than the taxpayer). Nonrecourse financing does not include financing with the taxpayer's own funds which did not result from borrowing. It is expected that the Treasury regulations may except "arms-length" recourse borrowing from otherwise unrelated commercial lenders from the prohibition against borrowing from a person with an interest in the activity (or a related person).

The bill provides an exception for qualified commercial financing similar to that under present law. Qualified commercial financing includes financing (other than convertible debt) provided or guaranteed by any Federal, State or local government, or borrowed from a qualified person. Qualified persons include any person actively and regularly engaged in the business of lending money. However, qualified persons do not include (1) any person related to the taxpayer, (2) any person from which the taxpayer acquired the property (or a person related to such person), or (3) any person who receives a fee (e.g., a promoter) with respect to the taxpayer's investment in the property (or a person related to such person). For these purposes, the bill adopts the definition of related person contained in section 168(e)(4) (relating to accelerated cost recovery). Under this rule, related persons generally include family members, fiduciaries and corporations or partnerships in which a person has at least a 10-percent interest.

In order for the exception for qualified commercial financing to apply, the amount of nonrecourse financing with respect to the property cannot exceed 80 percent of the credit base. Additionally, the exception does not apply where property was acquired by the taxpayer from a related person.

The present law safe harbor rule for certain energy property is continued under the bill.

The bill provides that, in the case of partnerships or S corporations, the determination of whether financing is nonqualified nonrecourse financing is to be made at the partner or shareholder level. However, a special rule is provided for financing provided by a qualified person to an S corporation. Under this rule, an allocable share of such financing is treated as recourse to an S shareholder if the financing is recourse at the corporate level and is provided with respect to qualified business property. Such financing will therefore not count as nonqualified nonrecourse financing and will not reduce the credit base, regardless of whether the shareholder is personally liable for repayment. Qualified business property includes property used by the S corporation in an active trade or business which during the entire 12-month period ending on the last day of the taxable year has at least three full-time non-owner employees (as defined for purposes of the exemption for active closely held businesses) substantially all of whose services are directly related to the business. One full-time employee must also be involved in the active management of the business. Qualified property does not include master sound recordings or other tangible or intangible assets associated with literary, artistic or musical properties. The amount of any partner's or shareholder's allocable share of any financing will be determined according to the rules for allocation of the investment tax credit.

The bill also includes rules for the treatment of subsequent increases and decreases in nonqualified nonrecourse financing. These provisions are generally consistent with the treatment of changes in the at-risk amount under present law.

Credit pass-through leases

The bill provides specific at-risk rules applicable to credit pass-through leases. These rules apply to the same types of taxpayers and the same activities as the at-risk rules generally.

Under the pass-through at-risk rules, the lessee initially is allowed the full investment tax credit only if the lessee is at risk for (i.e., is obligated to make) rental payments the present value of which is equal to at least 30 percent of the the lessee acquisition amount (18 percent in the case of 3-year property). The lessee acquisition amount is the amount for which the lessee is treated as having acquired the property under the general pass-through rules (i.e., without regard to the amount at risk). In addition, the amount of the lessee's credit cannot exceed the amount of the credit which would have been allowed to the lessor had the lessor's basis in the property been the lessee acquisition amount and had the lessor not made the pass-through election. Thus, the lessee will receive the full credit only if the lessor is at risk with respect to the property (assuming the lessor is a taxpayer subject to the at-risk rules).

For purposes of the pass-through rules, the lessee is considered to be at risk with respect to rental payments which the lessee is required to make under the lease in all events, and for which the lessee is not protected against loss through guarantees, stop-loss arrangements, or other similar arrangements. The present value of at-risk rental payments is to be determined by discounting all future minimum required payments by the rate in effect (as of the time the lease is entered into) for determining interest on underpayments of tax (sec. 6621).

Where the lessee is at risk for rental payments the present value of which is less than 30 percent of the lessee acquisition amount (18 percent in the case of 3-year property), the lessee is allowed only a portion of the credit. The portion of the full credit allowed for any taxable year is that portion equal to the ratio of (1) the aggregate rental payments actually made during the taxable year to (2) the lessee acquisition amount. The full remaining amount of the credit is allowed in the first year in which the lessee has made aggregate rental payments equal to 30 percent or more of the lessee acquisition amount. For example, a lessee who makes rental payments equal to 10 percent of the lessee acquisition amount in each of years 1 and 2 (and who is not otherwise at risk for rental payments equal to at least 30 percent of the lessee acquisition amount) will be allowed one-tenth of the credit in each of those years. If the lessee makes a further 10 percent payment in year 3 (resulting in aggregate payments of 30 percent of the lessee acquisition amount), the lessee will be allowed the full remaining amount of the credit. (In the case of 3-year property, the percentage is 18 rather than 30 percent.)

The bill provides that, for purposes of applying the lessee at-risk rule to partnerships and S corporations, rules similar to those in effect under the general investment tax credit at-risk rules shall apply (i.e., the partners and shareholders must individually be at risk for their share of the minimum lease payments). Additionally, the treatment of subsequent reductions in the lessee's at-risk amount (e.g., by entering into guarantees or stop-loss arrangements with respect to future rental payments) are to be based on the principles applied under the general rule (sec. 47(d)). For purposes of the recapture rule, where the lessee actually made a rental payment, the determination of the lessee's at-risk amount is to be determined as if he were still at risk to make that payment.

The bill provides the Treasury Department with authority to prescribe regulations necessary to carry out the purposes of the lessee at-risk rules. Specifically, the Treasury is provided with authority to prescribe regulations providing appropriate adjustments to required rental payments where the lessor bears expenses connected with the lease which a lessee normally would bear,[18] and specifying the extent to which contingencies in the lease will be disregarded for at-risk purposes. It is expected that these regulations will take into account the normal business practices associated with lease transactions, such as forgiveness of rental payments where the property is destroyed or damaged. The option of the lessee to unilaterally terminate a lease is not a contingency to be disregarded for at-risk purposes. However, the regulations may provide that if termination of a lease is permitted upon payment of a fixed amount, the lessee is to be considered at-risk for the lesser of the present value of the noncontingent amount or the present value of future rental payments that would be due after the date on which the lease could be terminated. The lessee's right to substitute other leased property in the future (e.g., a newer model of a leased computer) is a contingency which may be disregarded if the minimum rental payments under the lease are not reduced upon such substitution.

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[18] No inference is intended that the Treasury would not have this authority without specific statutory authorization.

Exclusion for active closely held businesses

Under the bill, certain active businesses conducted by closely held subchapter C corporations are exempted from the at-risk rules, both the loss limitation and investment tax credit at-risk rules. (Non-closely held corporations are exempt from at risk under present law.) The exemption does not apply to personal holding companies (as defined in sec. 542(a)), foreign personal holding companies (as defined in sec. 552(a)) or personal service corporations (as defined in sec. 269A(b)(1), using a 5-percent shareholder test). Additionally, the exemption does not apply to (1) equipment leasing businesses [19] or (2) any business involving the exploitation, sale, or lease of master sound recordings, motion picture films, video tapes or other literary, artistic or musical assets, except to the extent the taxpayer is completely at risk with respect to all amounts paid or incurred in connection with the acquisition or creation of the properties used in the business. For this purpose, the provision of radio, television, cable television, or similar services pursuant to a license or franchise granted by the Federal Communications Commission or other Federal, State or local authority shall not be treated as an excluded business.

Under the bill, the exemption applies to active corporate businesses only if, during the entire 12-month period ending on the last date of the corporation's taxable year, the corporation had at least three full-time non-owner employees substantially all of whose services were directly related to such business. Also, at least one full-time employee of the corporation must perform services substantially all of which are in the active management of the business. In addition, the deductions for business expenses allowable to the corporation for the taxable year under sections 162 (relating to trade or business expenses) and 404 (relating to contributions to certain employee benefit plans) must exceed 15 percent of the gross income from the business.

For purposes of the 15-percent requirement, deductions for compensation for personal services rendered by certain shareholders of the corporation, or a member of a shareholder's family, are excluded from the computation amount. In the case of a bank or other financial institution, gross income includes tax-exempt interest, and amounts paid to depositors as interest or dividends are treated as business expenses. The 15-percent test will not apply to a qualified life insurance company (i.e., a company which would be a life insurance company determined without regard to its unearned premiums).

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[19] Certain corporate equipment leasing businesses are presently exempt from the at-risk rules.

For purposes of the three-employee requirement, non-owner employees include any employee owning (directly or indirectly) less than 5 percent of the outstanding stock of the corporation. In the case of a general partner, the taxpayer's share of the partnership activities shall be treated as activities of the taxpayer.

For purposes of the exemption for active closely held businesses, members of an affiliated group of corporations (sec. 1504(a)) are treated as a single taxpayer, except that the income of a personal holding company may not be offset by losses allowed by reason of the new trade or business exception to the at-risk rules.

Aggregation of activities

For purposes of the loss limitation at-risk rule, the bill provides that a taxpayer's activities with respect to separate films or video tapes, farms, oil and gas properties, geothermal properties, or leased personal property are to be treated as one activity (i.e., aggregated) if the activities constitute all or part of a trade or business and the taxpayer actively participates in the management of each activity (in the case of partnership or S corporation, if 65 percent or more of losses for the taxable year are allocable to persons who actively participate in management of the activity.) This is similar to the rule applicable under present law to other forms of investment. However, for purposes of the covered activities, the taxpayer may aggregate activities only if the taxpayer actively participates in the management of each separate activity to be aggregated. For example, a taxpayer may treat two or more oil properties as one activity only if the taxpayer actively participates in the management of each individual property. Such a taxpayer would then be entitled to deduct losses from the oil properties based on the amount of at-risk investment (including undistributed profits) in the aggregated properties.

The determination of whether a person actively participates in the management of an activity depends upon the facts and circumstances. Factors which tend to indicate active participation include participating in the decisions involving the operation or management of the activity, actually performing services for the activity, or hiring and discharging employees. Factors which tend to indicate a lack of active participation include lack of involvement in management and operation of the activity, having authority only to discharge the manager of the activity, or having a manager of the activity who is an independent contractor rather than an employee.

Borrowing from related parties

The bill provides that recourse borrowing from related parties (including family members and entities controlled by the taxpayer) may be considered at risk for purposes of the loss limitation and investment tax credit at-risk rules. Except as otherwise provided by regulations, recourse borrowing will be considered not at risk when the related party has an interest (other than as a creditor) in the activity or when the taxpayer is otherwise protected against loss. The bill also specifies that a corporation may be considered at risk with respect to amounts borrowed from its shareholders to finance participation in an activity.

Effective Date

The provisions applicable to the at-risk rules generally (including both the loss limitation and investment tax credit rules) will apply to taxable years beginning after December 31, 1983. The revision of the investment tax credit at-risk rules will apply to property placed in service after the date of enactment in taxable years ending after such date. However, at the election of the taxpayer, the investment tax credit provisions will apply as if included in the Economic Recovery Tax Act of 1981 (ERTA). Any such election will apply to all property of the taxpayer to which the ERTA rules applied.

Revenue Effect

This provision will have a negligible revenue effect.

D. Estate Tax Revisions

1. Permanent Rules for Reforming Governing Instruments Creating Charitable Remainder Trusts and Other Charitable Interests (sec. 441 of the bill and sec. 2055 of the Code)

Present Law

The Tax Reform Act of 1969 imposed new requirements that must be met in order for a charitable deduction to be allowed for income, gift, and estate tax purposes for the transfer of a split interest to charity (i.e., part charitable and part non-charitable). In the case of a remainder interest in trust, the interest passing to charity must be in either a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In addition, a deduction is allowed for a remainder interest in a farm or personal residence. In the case of an "income" interest passing to charity (i.e., a charitable lead trust), the "income" interest must be either a guaranteed annuity or a fixed percentage of the fair market value of the trust (determined at least annually).

Present law also allows the governing instruments of charitable split-interest trusts which where executed before December 31, 1979, to be amended to conform the governing instruments to the new requirements if the amendment is completed, or judicial proceedings necessary to amend the governing instrument are begun, by December 31, 1981.

Reasons for Change

Congress first permitted reformation of charitable remainder trusts in 1974 and since that time, the Congress has extended the period for reformations several times and extended the procedure to other types of split-interest charitable contributions. Even so, it has come to the attention of the committee that there are still many instruments providing for split-interest charitable contributions which do not meet the requirements for qualification under the rules of the Tax Reform Act of 1969. In many of these cases, disqualification results in reduced amounts passing to charity. In light of the repeated need to extend the period to reform such governing instruments and the fact that failure to meet the 1969 Act rules often results in reduced amounts passing to charity, the Committee believes that a permanent rule permitting reformation of split-interest charitable contributions should be permitted so long as there are adequate safeguards to avoid abuse.

Specifically, the committee is concerned that governing instruments of charitable split-interest trusts which evidenced no attempt to comply with the 1969 Act rules would be reformed only when the defects are found upon audit by the Internal Revenue Service. In order to prevent this from occurring, the committee believes that, in order for a governing instrument of a charitable split-interest contribution to be reformable, either (1) the creator had to make a bona fide attempt to comply with the 1969 Act rules or (2) the taxpayer must initiate reformation proceedings before the Internal Revenue Service could reasonably be expected to begin audit. The committee believes that these rules will permit the correction of major, obvious defects (such as where the "income" interest is not expressed as an annuity interest or a unitrust interest) so long as the taxpayer initiates reformation proceedings before audit, while allowing the correction of minor defects (such as defects in determining the correct payout in short taxable years, in years of additional contributions, etc.) upon audit so long as there was a good faith attempt to comply with the 1969 Act rules (i.e., the payout is basically expressed as an annuity interest or a unitrust interest).

Secondly, the committee believes that any reformation proceedings necessary to cure defective governing instruments should not be an opportunity to significantly revise the substance of the split interest transfer, especially where the change reduces charity's share of the trust. Accordingly, the committee believes that the relative actuarial values of the interests of each beneficiary before and after the reformation should not differ by more than that 5 percent and that the durations of the interests before and after the reformation should be the same. In addition, to insure that the reformation not be used to increase the amount of any charitable contribution deduction allowed with respect to the original transfer, the committee believes that the deduction under the reformed governing instrument not exceed the actuarial value of the charitable interest before the reformation.

Explanation of Provision

In general

The bill provides a permanent rule permitting reformation of governing instruments of charitable split interest trusts which do not meet the requirements of the 1969 Act rules. In general, such reformations will be allowed where either the instrument evidences an intent to comply with the 1969 Act rules or the reformation proceedings are begun before there is an opportunity by the Internal Revenue Service to audit the matter. In addition, the bill requires that the actuarial values and durations of the charitable and noncharitable interest in the trust generally must remain the same before and after the reformation. These results are achieved under the bill by allowing an income, gift, or estate tax charitable deduction for property passing to charity in respect of any qualified reformation of a reformable interest into a qualified interest.

Qualified reformation

A qualified reformation is a change in the governing instrument of a trust which changes a reformable interest into a qualified interest if two requirements are met. As under present law, the reformation must be retroactive to the date of death in the case of testamentary trusts or the date of creation in the case of inter vivos trusts and should provide for correction of any overpayments or underpayments prior to reformation. In order to insure the proper taxation of the trust and its beneficiaries, the bill provides that the period for assessing any deficiency of any tax shall not expire before the date which is one year after the Secretary of the Treasury is notified that the reformation had occurred.

Under the first requirement, the difference between the actuarial value of the charitable interests of the reformed trust and the unreformed trust cannot exceed 5 percent of the actuarial value of the charitable interest before the reformation.[20]

The second requirement limits changes in the length of the charitable and noncharitable interests in the trust. In the case of a charitable remainder trust, the noncharitable interests must terminate at the same time both before and after the reformation.[21] An exception is made to this rule to permit a noncharitable interest which is for a term of years in excess of 20 years to be reduced to 20 years.[22] In the case of other interests (e.g., charitable lead trusts), the charitable interest must be the same duration under both the reformed and unreformed trusts.

Reformable interest

In order for an interest to be a reformable interest, it must meet two requirements. First, the charitable interest prior to the reformation must have been in a form for which a deduction would have been allowable for that interest under the rules applicable to split interest transfers prior to the Tax Reform Act of 1969.

Second, either the reformation must be commenced[23] within a specified period or, in the case of wills executed after December 31, 1978, the will creating the trust must have evidenced an intent to comply with the 1969 Act. The specified period generally is the period that ends 90 days after the filing date (including extensions) of the estate tax return on which a charitable deduction for the transfer to the trust is claimed. If no estate tax return is required to be filed for such a transfer, the period terminates 90 days after the due date (with extensions) for the first required income tax return for the trust. The committee intends that, in order for the commencement a judicial proceeding to be timely, the pleading must describe the nature of the defect that must be cured. The filing of a general protective pleading is not sufficient.

The governing instrument evidences an intent to comply with the 1969 Act rules if all current payouts from the trust are expressed as a fixed dollar amount or a fixed percentage of the value of the trust's assets. Thus, a trust does not meet this requirement if the governing instrument provides for powers of invasion for a noncharitable beneficiary of any sort. However, the failure to have detailed rules relating to the computation of the fixed dollar amount or the fixed percentage of the value of the trust's assets in special circumstances (e.g., short taxable years, years where there are additional contributions, year when interests terminate, etc.) will not cause the interests to not be reformable interests. In addition, an interest will be treated as expressed as a fixed percentage of the value of the trust's assets if the current payout is expressed as the lesser of trust income or a fixed percentage of the value of the trust's assets or the current payout is expressed in any other formulation which indicates an intent to create a trust described in section 664(d)(3).

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[20] Under the bill, a reformation that changes the relative interests of noncharitable beneficiaries may be a qualified rright to substitute other leased property in the future (e.g., a newer model of a leased computer) is a contingency which may be disregarded if the minimum rental payments under the lease are not reduced upon such substitution.

[21] Where the unreformed trust contains a contingency which accelerates the charitable remainder interest, the actuarial value of the charitable and noncharitable interests before the reformation is to be determined, for this purpose, without regard to the contingency.

[22] In such a case, the amount of the annual noncharitable distributions must be increased to insure that the actuarial value of the charitable and noncharitable interests are the same before and after the reformation.

[23] Where a judicial proceeding is begun in one court, but it is later determined that the proceeding should have been commenced in a different court (for example, where it is determined that jurisdiction over the trust lies in a different State), then the proceeding will be treated as timely filed if the first proceeding was timely filed.

Method of reformation

The bill provides that the qualified reformation can be achieved in any method permitted under applicable local law so long as that change is binding on all relevant parties under applicable local law. Thus, changes can be accomplished by reformation, amendment, construction, or otherwise, so long as those changes are binding on all parties under applicable local law.

In addition, the bill provides the the death of all of the noncharitable "income" beneficiaries of a charitable remainder trust before the filing of the estate tax return (including any extensions) on which the charitable deduction for the transfer to the trust is claimed is to be treated as a reformation of the governing instrument of the trust. In such a case, the charitable deduction is the actuarial value of the remainder interest before the reformation, adjusted for any payments made to those "income" beneficiaries.

Amount of deduction allowed

If there is a qualified reformation, a deduction is allowed for the lesser of (1) the actuarial value of the charitable interest after the reformation or (2) the amount of the actuarial value of the charitable interests prior to the reformation for which a deduction would have been allowable but for the disallowance rules of section 2055(e)(2).[24]

Effect of reformation for other purposes

The bill provides that the Secretary of the Treasury shall prescribe regulations concerning the taxation of trust and the application of the rule relating to exempt organizations and private foundations to trusts which are reformed pursuant to the provisions of the bill. The committee intends that those regulations continue the present law rule that, in the case of a reformation of a charitable remainder trust, the exemption from tax and the income characterization of payments provided by section 664 will be retroactive to the creation of the trust.

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[24] In determining the actuarial value of the charitable interest of the unreformed trust, the committee intends that trust to which Rev. Proc. 73-9, 1973-1 C.B. 758, apply are to be treated as if they had complied with that revenue procedure.

Pooled income funds, farms, and personal residences

The bill provides that the Secretary of the Teasury is to prescribe rules permitting the reformation of charitable transfers involving remainder interests in pooled income funds, farms, and personal residences. The rules to be prescribed are to be consistent with the rules provided by the bill for reformations of charitable remainder annuity trusts and charitable remainder unitrusts.

Special rule for contingencies in charitable remainder trusts

The bill provides a special exception to the present law rule that the noncharitable interests in a charitable remainder annuity trust or a charitable remainder unitrust must terminate at the end of lives in being or a term of years (not to exceed 20 years). Under the special exception, contingencies in the time that annuity trust interest or unitrust interest payments are to be made, are permitted where a trust provides for annuity trust interests or unitrust interests which terminate at times permitted by present law, but provides that those annuity trust interests or unitrust interests terminate at some earlier time such that the charitable remainder interest is accelerated. For example, under the bill, the annuity trust interest or unitrust interest may be paid for the earlier of death or remarriage of a named individual. In such a case, the value of the charitable remainder is determined without regard to the contingency (i.e., the value of the charitable remainder is determined as if the payments of the annuity trust interest or unitrust interests did not terminate until the periods permitted by present law). For example, where the annuity trust interest or unitrust interest lasts until the earlier of the death or remarriage of a named individual, the value of the remainder interest is determined as if the annuity trust interest or unitrust interests terminated at the death of the named individual.

Effective Date

The amendments made by this section apply to reformations made after December 31, 1978, other than reformations to which present law (as in effect prior to this bill) applies). The bill also provides a special rule which opens the statute of limitations for one year after the date of enactment. Thus, in the case of a reformation in 1979 of a trust created pursuant to a will executed in 1979, the statute of limitations with respect to the estate tax deduction with respect to transfers to the trust or with respect to the income taxation of the trust shall not expire later than one year after the date of enactment. However, where a credit or refund is made which is allowed by reason of the extension of the statute of limitations, no interest is allowable on such claim or refund for the period before 180 days after the Secretary of the Treasury is notified of the reformation.

Revenue Effect

This provision will decrease revenues by less than $5 million per year.

2. Alternate Valuation Date Election (secs. 442 and 443 of the bill and sec. 2032 of the Code)

Present Law

Under present law, the value of property included in the decedent's gross estate for Federal estate tax purposes generally is determined on the date of the decedent's death. However, the executor of the decedent's estate may elect to have the value of all property included in the gross estate determined as of the alternate valuation date, which generally is the date six months after the date of the decedent's death. The election to use the alternate valuation date may be made only on a timely filed Federal estate tax return. The election may be made whether or not the Federal estate tax liability of the estate is reduced.

Also under present law, the basis of property acquired from a decedent in the hands of the decedent's estate or his heirs generally is the value of that property determined for Federal estate tax purposes (i.e., basis is "stepped up" or "stepped down" to fair market value at death or alternate valuation date).

Reasons for Change

The purpose in providing an election to use the alternative valuation date was to provide relief for estate tax purposes where the value of the property decreased after death so that estate taxes are not inordinate. However, the committee believes that election to use the alternate valuation date has been abused.

Where property has appreciated in value since the date of the decedent's death, it is possible under present law to elect the alternate valuation date to increase the income tax basis of the property even though there is no additional Federal estate tax arising from the election. No estate tax may be due either because the estate is not sufficiently high in value or because the appreciated property is transferred to the decedent's surviving spouse.

Because the purpose of the election to use the alternate valuation date was to provide estate tax relief and not as a general method of avoiding income taxes the committee believes that the election to use the alternate valuation date should be restricted to cases where estate tax consequences are affected.

In addition, the committee believes that there is no reason for requiring that the election be made on a timely fixed estate tax return so long as the Internal Revenue Service is given an adequate opportunity to determine correct tax liabilities after the election is made.

Explanation of Provision

The bill provides that the election to use the alternate valuation date may be made only where both the total value of all property in the gross estate and the Federal estate tax liability of the estate are both reduced.

The bill also provides that the election to use of the alternate valuation date may be made on the first estate tax filed (whether filed timely or late). Once an election is made, it is irrevocable. Where the election to use the alternate valuation date is made on a late estate tax return, the period for assessing any deficiency shall not expire before the date which is one year after the date the election is made.

Effective Date

These provisions will be effective with respect to decedents dying after the date of enactment of the bill.

Revenue Effect

The provision allowing the election only where it results in a reduction in gross estate and estate tax will increase revenues by less than $10 million annually. The provision relating to time for filing the election will reduce revenues by less than $1 million annually.

E. Foreign Tax Provisions

1. Resident Aliens (sec. 451 of the bill and sec. 7701(b) of the Code)

Present Law

Resident aliens, like U.S. citizens, are subject to U.S. income tax on their worldwide income at the regular graduated rates. Nonresident aliens are subject to U.S. tax only to the extent their income is from U.S. sources or is effectively connected with the conduct of a trade or business within the United States. Certain passive U.S. source income of nonresident aliens is subject to tax at a flat 30-percent rate, while effectively connected income is generally subject to taxation on a net basis at graduated rates. Bilateral income tax treaties may modify the U.S. taxation of a nonresident alien.

The Internal Revenue Code does not define the terms "resident alien" or "nonresident alien." Treasury Regulations generally apply a subjective test and define the terms on the basis of an alien's intentions with regard to the length and nature of his or her stay (Treas. Reg. sec. 1.871-2). In general, under the regulations, residence depends on whether an alien is "a mere transient or sojourner" in the United States. Living in the United States with no definite intention as to the length and nature of his or her stay makes an alien a resident under the regulations. A visa that limits the alien's stay to a definite period makes him or her a nonresident absent "exceptional circumstances." An alien may be a resident for tax purposes although neither a resident for immigration purposes nor present in the United States for half the year (*Tongsun Park* v. *Commissioner*, 79 T.C. No. 17, August 10, 1982). An individual may be a resident of more than one country.

An alien may be taxable as a resident for part of a year and taxable as a nonresident for the balance of the year.

In certain cases, individuals who earn U.S.-source income may seek to minimize their U.S. tax by claiming that they are taxable on a fiscal year basis rather than on a calendar year basis and thereby allocating their U.S. income into more than one fiscal year if such an allocation is beneficial (*e.g.*, if they have income for only a part of some fiscal year).

Reasons for Change

The committee believes that the tax law should provide a more objective definition of residence for income tax purposes. The committee believes that present law does not provide adequate guidance with respect to residence status. The committee understands that an objective definition may allow some aliens who should be taxable as residents to avoid resident status, and would impose resident status on some aliens who are not residents under the current rules. On balance, however, the committee finds that the certainty that the bill's objective definition provides outweighs other considerations.

The committee believes that aliens who have entered the United States as permanent residents and who have not officially lost or surrendered the right to permanent U.S. residence should be taxable as U.S. residents. These persons have rights that are similar to those afforded citizens (including the right to enter the United States at will); equity demands that they contribute to the cost of running the government as much as citizens.

It is just as clearly appropriate to treat as residents individuals who spend significant time in the United States. While there is no single system that is perfect, the committee believes that a regime that depends on length of stay meets the criteria of objectivity and establishing nexus to the United States and is appropriate. Almost all individuals present in the United States for more than half a year should be taxable as U.S. residents. Moreover, individuals who repeatedly spend significant amounts of time in the United States should have to note their presence with the Internal Revenue Service; if they do not have a closer connection with a foreign country than with the United States and a tax home in that foreign country, they, too, should be taxable as U.S. residents. The committee believes that an average of 122 days of presence over a three year period is a significant amount of time for the purpose of imposing U.S. tax in such circumstances, but that an individual who is present for fewer than 31 days in a year should not be subject to this rule for that year. The committee believes that the Tax Court reached the proper result in the *Park* case, and believes that a residence definition based solely on 183 (or some other number of) days of presence in one year would be inadequate.

The committee recognizes that there are cases in which, because of the reason for the alien's stay in the United States, full U.S. taxation is inappropriate. Accordingly, the bill provides exceptions when aliens come to the United States to teach or to learn rather than for employment, for business, for economic opportunity, for pleasure, for personal or family reasons, for political stability, or for other reasons. Exceptions to the general rules for some students, teachers, and trainees will allow the United States to maintain its paramount position in the field of education. Exceptions also seem appropriate for diplomats and for some persons unable to leave the United States.

The committee believes that alien taxpayers who spend brief amounts of time in the United States before moving here or after moving away should generally not be taxable as residents during those brief periods, or during the time between the brief stays and the time the taxpayer moves. The committee also believes that aliens should not be able to switch back and forth between resident status and nonresident status for short periods, and that there should be no gap in resident status when an alien is a resident for part of two consecutive years.

The committee believes that the bill's definition of residence imposes U.S. tax on aliens only when their relationship with the United States is so close that U.S. inclusion of worldwide income in the tax base is appropriate. (Resident aliens, like U.S. citizens, will continue to credit foreign taxes on foreign income or taxes in lieu thereof.) Special rules to exempt foreign passive income of some (but not all) resident aliens are therefore not appropriate. The committee believes that some wealthy aliens spend much time in the United States because of the political stability or economic opportunities our country affords. The committee believes that these aliens should share with other U.S. persons in the financial responsibility for the operations of the Federal Government, even if most of their income is foreign. For reasons of simplicity, too, the committee does not believe that there should be two classes of residents for tax purposes.

The committee believes that aliens who cannot leave the United States because of a medical condition that arose during their stay here should not automatically be subject to U.S. taxation as residents if here for 183 days. The committee also believes, however, that the Federal Government has contributed to the creation of medical facilities in the United States that are second to none in the world, and that aliens who come to the United States for medical treatment and stay for extended periods of time should be subject to the bill's regular rules.

Explanation of Provision

Definition of resident alien— general rules

The bill provides a definition of resident alien for U.S. income tax purposes. (The bill does not affect the definition of resident for Federal estate or gift tax purposes.) Aliens who do not meet this definition will be nonresident aliens. For income tax purposes, an individual will be considered a resident if the individual:

(1) has entered the United States as a lawful permanent U.S. resident (the "green card test"); or

(2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time—as many as 183 days during a 3-year period weighted toward the present year (the "substantial presence test").[25]

If an individual is present in the United States for fewer than 183 days during the calendar year, and if the individual establishes that he or she has a closer connection with a foreign country than with the United States and a tax home in that country for the year, the individual will generally not be subject to tax as a resident on account of the substantial presence test. For this purpose, tax home means the individual's home for purposes of section 162(a)(2) (relating to traveling expenses while away from home) (see sec. 911(d)(3)). Thus, maintenance of a U.S. abode will not automatically prevent an individual from establishing a tax home in a foreign country. If an individual is present for as many as 183 days during a year, this closer connections/tax home exception will not be available.

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[25] This substantial presence test will compare 183 days to the sum of (1) the days present during the current calendar year, (2) one-third of the days present during the preceding calendar year, and (3) one-sixth of the days present during the second preceding calendar year. An average of 122 days of presence over three years will trigger the test.

An alien who has an application pending to change his or her status to permanent resident or who has taken other steps to apply for status as a lawful permanent U.S. resident will not be eligible for the closer connections/tax home exception. Under current immigration rules, a relative of an alien may apply for the alien to become a lawful permanent U.S. resident. An application by another person will not be relevant under the bill. The closer connections/tax home exception will become unavailable only when an alien takes an affirmative step to seek permanent resident status. Under current procedures, the filing of a Biographic Information form (now Immigration and Naturalization form G-325A) will constitute an affirmative step to seek permanent resident status when another individual has begun the immigration procedure for the alien.

In addition, days present as an "exempt individual," a term that includes certain foreign government related individuals, teachers, trainees, and students will not count as days of U.S. presence for the substantial presence test.

The bill defines the term "foreign government-related individual" to mean any individual temporarily present in the United States by reason of (1) diplomatic status, or a visa which the Secretary of the Treasury (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status; (2) being a full-time employee of an international organization; or (3) being a member of the immediate family of such a diplomat or international organization employee. For this purpose, international organizations are those entitled to the benefits of the International Organizations Immunities Act (see Code sec. 7701(a)(18)).

The term "teacher or trainee" means any individual who is temporarily present in the United States under subparagraph (J) of section 101(15) of the Immigration and Nationality Act[26] (other than as a student), and who substantially complies with the requirements for being so present. An individual will not be able to establish substantial compliance with this or any visa requirement relevant to residence for tax purposes merely by showing that his or her visa had not been revoked. That is, there is to be an independent redetermination, for tax purposes, of whether an alien has substantially complied with visa requirements.

A "student" is any individual who is temporarily present in the United States either under subparagraph (F) of section 101(15) of the Immigration and Nationality Act,[27] or as a student under sub-

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[26] Subparagraph (J) of section 101(15) of the Immigration and Nationality Act now applies to "an alien having a residence in a foreign country which he has no intention of abandoning who is a bona fide student, scholar, trainee, teacher, professor, research assistant, specialist, or leader in a field of specialized knowledge or skill, or other person of similar description, who is coming temporarily to the United States as a participant in a program designated by the Secretary of State, for the purpose of teaching, instructing or lecturing, studying, observing, conducting research, consulting, demonstrating special skills, or receiving training and who, if he is coming to the United States to participate in a program under which he will receive graduate medical education or training, also meets the requirements of section 1182 of this title, and the alien spouse and minor children of any such alien if accompanying him or following to join him." The definition for purposes of this tax legislation will change from time to time as the definition in the Immigration and Nationality Act changes.

[27] Subparagraph (F) of section 101(15) of the Immigration and Nationality Act now applies to "(i) an alien having a residence in a foreign country which he has no intention of abandoning, who is a bona fide student qualified to pursue a full course of study and who seeks to enter the

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paragraph (J) of such section 101(15), and who substantially complies with the requirements for being so present.

An individual cannot be exempt from the substantial presence test as a teacher or trainee if he or she has been exempt as a teacher, trainee, or student for any part of two of the six preceding calendar years. An individual cannot be exempt from the substantial presence test as a student if he or she has been exempt as a teacher, trainee, or student for more than five calendar years, unless that individual establishes to the satisfaction of the Secretary of the Treasury that he or she does not intend to reside permanently in the United States and that he or she has substantially complied with the requirements of the student visa providing for the individual's temporary presence into the United States.

An individual who cannot physically leave the United States because of a medical condition that arose during the individual's presence here is eligible for the closer connections/tax home exception to the substantial presence test even if present here for more than 182 days during the year. The committee anticipates that few individuals will be physically unable to leave the United States. For example, an individual who is in a serious automobile accident shortly before a planned departure date could come within this category. These individuals will have to establish to the satisfaction of the Secretary of the Treasury that they qualify for this special medical exception.

The bill defines lawful permanent resident to mean an individual who has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, if such status has not been revoked or administratively or judicially determined to have been abandoned. Therefore, an alien who comes to the United States so infrequently that, on scrutiny, he or she is no longer legally entitled to permanent resident status, but who has not officially lost or abandoned that status, will be a resident for tax purposes.

Presence during a day will be presence at any time during the day. Regular commuters to employment or self employment in the United States from a place of residence in Canada or Mexico will not be treated as present in the United States on days when they so commute.

The Secretary of the Treasury is authorized to require aliens who claim exemption from the substantial presence test (whether under the closer connection/tax home exception or any other exception) to file statements explaining the basis for their exemption. It will be within the discretion of the Secretary to impose such requirements by regulation.

United States temporarily and solely for the purpose of pursuing such a course of study at a college, university, seminary, conservatory, academic high school, elementary school, or other academic institution or in a language training program in the United States, particularly designated by him and approved by the Attorney General after consultation with the Secretary of Education, which institution or place of study shall have agreed to report to the Attorney General the termination of attendance of each nonimmigrant student, and if any such institution of learning or place of study fails to make reports promptly the approval shall be withdrawn and (ii) the alien spouse and minor children of any such alien if accompanying him or following to join him." The definition for purposes of this tax legislation will change from time to time as the definition in the Immigration and Nationality Act changes.

A taxpayer who has not established a taxable year for any prior period will be taxed on a calendar year basis. A taxpayer who establishes a fiscal year will determine residence on a calendar year basis, and will be subject to tax as a resident for any portion of his fiscal year within a calendar year of residence.

The definition of resident alien contained in the bill could conflict with existing treaty obligations of the United States. That is, the definition in the bill could cause an alien to be a U.S. resident, while "tie-breaker" rules in an income tax treaty could indicate that the alien is a resident of the treaty partner (see, e.g., Article 4 of the U.S. Model Income Tax Treaty, and Article 4(2) of the U.S.-United Kingdom Income Tax Treaty). The committee does not intend to override treaties on this point; therefore, in such a case, the treaty definition will prevail, and such an alien will not be taxable as a resident of the United States.

The committee, in changing the definition of U.S. residence for U.S. tax purposes, is not changing the definition of foreign residence for U.S. tax purposes. Therefore, the term "bona fide resident of a foreign country" for the purposes of the tax benefits for foreign earned income will retain its current meaning (sec. 911(d)(1)(A)). Therefore, a U.S. citizen who is present in a foreign country for 183 days during a calendar year will not automatically be a "bona fide resident" of that country.

Time of residence

Beginning of residence

An alien who was a U.S. resident during the preceding calendar year and who is a U.S. resident for the current year will continue to be taxable as a resident at the beginning of the current year. That is, residence for tax purposes will not lapse, but will continue throughout both years. For example, an alien who is present in the United States from January 1 to August 1 in 1985 and from June 1 to December 31 in 1986 will be a U.S. resident for all of 1985 and 1986. Similarly, an alien who is present in the United States from January 1 to August 1 in 1985, who first arrives in the United States in 1986 on December 1, and who becomes a lawful permanent U.S. resident on December 1, 1986, will be a U.S. resident for all of 1985 and 1986.

An alien who was not a U.S. resident during the preceding calendar year but who is a U.S. resident for the current year will begin to be a resident for tax purposes on his or her residency starting date, which may not be the beginning of the current year.

An alien who first becomes a lawful permanent resident (and thus first satisfies the "green card" test) during the year will ordinarily begin to be a U.S. resident for tax purposes on the first day he or she was present in the United States while a lawful permanent resident of the United States. If the alien was a U.S. resident during the preceding year, however, residence for tax purposes will not lapse, but will continue throughout both years. If an individual was a lawful permanent U.S. resident during all of 1984, he or she will generally be a U.S. resident during all of 1985, whether or not he or she is present in the United States during 1985.

An alien who was not a resident during the preceding year but who satisfies the substantial presence test for the current year will ordinarily begin to be a U.S. resident for tax purposes on the first day during the year when he or she is physically present in the United States. The bill creates an exception, however, for certain nominal presence during the year. (This nominal presence exception does not postpone the beginning of residence under the "green card" test.) If an alien meets only the substantial presence test for the year, but spends time when he or she has a closer connection to a foreign country than to the United States, the alien may not begin to be a resident for tax purposes during a period of ten or fewer days during that time. The purpose of this nominal presence exception is to allow brief presence in the United States (for example, for business or for house-hunting) before moving to the United States without triggering residence status.

For example, an alien (who has never before been a U.S. resident for tax purposes) who lives in Spain until May 15, who moves to the United States on May 15 and who remains in the United States through the end of the year will begin to be a U.S. resident for tax purposes on May 15. Similarly, an alien (who has never before been a U.S. resident for tax purposes) who lives in Spain until May 15, who comes to a business meeting in the United States on February 2 through 8, who moves to the United States on May 15 and who remains in the United States through the end of the year will begin to be a U.S. resident for tax purposes on May 15, if he or she can establish a closer connection to a foreign country (presumably Spain in this example) than to the United States for the period of U.S. presence in February. However, the committee does not believe that an alien will end (or begin) a closer connection with a foreign country while physically present in the United States. For example, an alien continuously present in the United States from May 1 to December 31 only, during a year, will not be eligible for this nominal presence rule for any part of the first ten days of May.

If an alien was not a resident during the preceding year but satisfies the substantial presence test as well as the "green card" test for the current year, his or her residence for tax purposes will begin on the earlier of (1) the first day he or she was present in the United States while a lawful permanent resident of the United States or (2) his or her residency starting date under the substantial presence test. For example, if such an alien (1) is present in the United States from January 1 to May 1 and from October 1 to December 31 and (2) first meets the "green card" test on November 1, his or her residence for tax purposes will begin on January 1.

Termination of residence.—An alien who is a U.S. resident during the current year and who is also a U.S. resident during the following year will be taxable as a resident through the end of the current year. That is, residence for tax purposes will not lapse, but will continue throughout both years. An alien who is a U.S. resident during the current year but who is not a U.S. resident for the following year may or may not be taxable as a U.S. resident through the end of the current year.

An alien who ceases to be a lawful permanent resident (and thus ceases to satisfy the "green card" test) during the year will typically cease to be a U.S. resident for tax purposes on the first day he or she is no longer a lawful permanent resident of the United States. If the alien is a U.S. resident (under either the "green card" test or the substantial presence test) during the following year, however, residence for tax purposes will not lapse, but will continue throughout both years.

An alien who is not a resident during the following year but who satisfies the substantial presence test for the current year will ordinarily cease to be a U.S. resident for tax purposes on the last day during the year when he or she is physically present in the United States. The bill creates an exception, however, for certain nominal presence during the year. If an alien meets the substantial presence test for the year, but spends ten or fewer days in the United States at a time when he or she has a closer connection to a foreign country than to the United States, the alien will not be a resident for tax purposes during that period of ten or fewer days. The purpose of this nominal presence exception is to allow brief presence in the United States (for example, for business or for disposing of a U.S. residence) without extending residence status. Again, this nominal presence exception does not apply to aliens meeting the "green card" test.

For example, an alien (who is not during the following year a U.S. resident for tax purposes) who lives in the United States until September 15, who moves to Brazil on September 15, and who does not return to the United States during the year will cease to be a U.S. resident for tax purposes on September 15. Similarly, an alien (who is not during the following year a U.S. resident for tax purposes) who lives in the United States until September 15, who moves to Brazil on September 15, and who comes to a business meeting in the United States on November 2 through 8 will cease to be a U.S. resident for tax purposes on September 15, if he or she can establish a closer connection to a foreign country (presumably Brazil, in this example) than to the United States for the period of U.S. presence in November.

If an alien is not a resident during the following year but satisfies the substantial presence test as well as the "green card" test for the current year, his or her residence for tax purposes will end on the later of (1) the first day he or she is no longer a lawful permanent resident of the United States or (2) the last day he or she was a resident under the substantial presence test. For example, if an alien who is not a resident during the following year (1) is present in the United States from January 1 to August 1 and from October 1 to October 5, (2) can establish a closer connection to a foreign country than to the United States for the period of U.S. presence in October, and (3) suffers revocation of his or her "green card" on November 1, his or her residence for tax purposes will end on November 1. If "green card" revocation occurred on September 15 in this example, however, residence would end on September 15. If "green card" revocation occurred on October 3, residence would end on October 3. If "green card" revocation occurred on March 5, residence would end on August 1.

Effective Date

These provisions will apply to taxable years beginning after December 31, 1984. However, pre-1985 presence of an alien who was not a resident (under current law) at the close of 1984 will not count in the substantial presence test; pre-1984 presence of an alien will count only if that individual was a resident (under current law) at the end of both 1983 and 1984.

Revenue Effect

The provisions will increase budget receipts by less than $10 million annually.

2. Treatment of Community Property Income of Nonresident Aliens (sec. 452 of the bill and sec. 879 of the Code)

Present Law

Nonresident aliens are subject to U.S. tax at the regular graduated rates on income that is effectively connected with the conduct of a trade or business within the United States. If one spouse is a U.S. citizen or resident while the other is a nonresident alien, the earned income of one spouse, the trade or business income of one spouse, the partnership share of trade or business income of one spouse, or the community income from the separate property of one spouse is generally treated as the income of that spouse (sec. 879). Therefore, if that income is effectively connected income, the couple generally may not split that income for U.S. tax purposes by use of community property laws. However, if both spouses are nonresident aliens from a community property country, they may be able to split the effectively connected income of one spouse to reduce their U.S. tax liability. A comparable couple from a common law country cannot split income in this way.

Reasons for Change

The committee believes that the U.S. income tax treatment of nonresident aliens from community property countries should be the same as the U.S. income tax treatment of nonresident aliens from common law countries. A graduated income tax like that of the United States imposes less tax on a given amount of income if the income belongs to more than one person. Therefore, when married taxpayers split their income, they generally reduce their combined tax liability. The committee does not believe that nonresident aliens who earn income that is effectively connected with a U.S. trade or business should be able to split that income for U.S. tax purposes by virtue of foreign community property laws. Furthermore, it does not believe that such a couple should be taxed more favorably than a similarly situated U.S. couple.

Explanation of Provision

The bill provides that, for U.S. income tax purposes, a married couple both of whom are nonresident alien individuals would treat the earned income of one spouse, the trade or business income of one spouse, the partnership share of trade or business income of one spouse, or the community income from the separate property of one spouse as the income of that spouse, regardless of any community property laws. That spouse will be subject to U.S. tax at the regular graduated rates applicable to married persons filing separate returns when such income is effectively connected with the conduct of a U.S. trade or business.

Effective Date

This provision will apply to taxable years beginning after December 31, 1984.

Revenue Effect

This provision will reduce budget receipts by less than $1 million annually.

3. Foreign Personal Holding Company Attribution Rules (sec. 453 of the bill and secs. 551 and 554 of the Code)

Present Law

In general

Congress enacted the foreign personal holding company rules to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks." If five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation that has primarily foreign personal holding company income (generally passive income such as dividends, interest, royalties, and rents (if rental income does not amount to 50 percent of gross income)), that corporation will be a foreign personal holding company. In that case, the foreign corporation's U.S. shareholders, including U.S. citizens, residents and corporations, are subject to U.S. tax on their pro rata share of the corporation's undistributed foreign personal holding company income. That is, though only individuals count in the determination of foreign personal holding company status, persons other than individuals may be subject to foreign personal holding company tax.

Family attribution for characterization as a foreign personal holding company

The foreign personal holding company provisions contain constructive ownership rules that determine whether a foreign corporation is more than 50 percent owned by five or fewer United States citizens or residents. These rules treat an individual as owning stock owned, directly or indirectly, by or for his or her partners, brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. One case, however, casts doubt on the operation of these constructive ownership rules when nonresident aliens are the only family members who own stock in a foreign corporation.[28]

These constructive ownership rules also apply to deem income to be foreign personal holding company income in two cases: (1) when a foreign corporation has contracted to furnish personal services that an individual who owns, directly or indirectly, 25 percent or more in value of the outstanding stock of the corporation has performed, is to perform, or may be designated to perform; and (2) when an individual who owns, directly or indirectly, 25 percent or more in value of the outstanding stock of the corporation is entitled to use corporate property and when the corporation in any way receives compensation for use of that property. This latter rule prevents foreign corporations from avoiding foreign personal holding company status by generating what appears to be large amounts of rental income.

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[28] In *Estate of Nettie S. Miller v. Commissioner*, 43 T.C. 760 (1965), nonacq., 1966-1 C.B. 4, two Canadian sisters owned over half the stock of a Canadian corporation. A divided Tax Court, despite the language of the statute, declined to attribute their stock to their brother, a U.S. citizen and resident, who owned none of the stock. Therefore, the corporation was not a foreign personal holding company, so its U.S. shareholders, who were unrelated to the Canadian sisters, were not subject to tax.

Income inclusion through foreign entity

Shareholders in a foreign personal holding company who are U.S. citizens or residents, U.S. corporations, U.S. partnerships, or estates and trusts (other than estates and trusts whose gross income includes only income from sources within the United States)[29] must include their share of undistributed foreign personal holding company income in their gross income. These shareholders are called "United States shareholders". If a foreign personal holding company is a shareholder in another foreign personal holding company, the first company includes in its gross income, as a dividend, its share of the undistributed foreign personal holding company income of the second foreign personal holding company.

Interposition of a foreign partnership, a foreign corporation other than a foreign personal holding company, or an estate or a trust whose gross income includes only income from sources within the United States between a taxpayer and a foreign personal holding company, however, arguably may allow avoidance of the foreign personal holding company rules. Although stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by its shareholders, partners, or beneficiaries for the purpose of determining whether a corporation is a foreign personal holding company, some taxpayers have taken the position that these tracing rules do not necessarily apply to impose a tax on the ultimate owners of a foreign personal holding company.

Reasons for Change

The foreign personal holding company provisions have been in the law since 1937 and serve an important purpose in removing the tax incentive to shift assets offshore often to tax havens. Two technical problems have come to the committee's attention. First, the committee believes that attribution of ownership from a nonresident blood relative for the purpose of determining whether a foreign corporation is a foreign personal holding company is generally inappropriate, particularly where the U. S. person to whom the stock is attributed owns no stock. Second, the committee is aware that the present rules have allowed taxpayers to take the position that they can circumvent the foreign personal holding company rules by interposing foreign entities between themselves and foreign personal holding companies. This abuse of the system was not intended and should be stopped.

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[29] This excluded category of estates and trusts corresponds generally to the definition of "foreign estate or trust" in Internal Revenue Code section 7701(a)(31). Therefore, in general, estates or trusts that are United States persons are subject to the same treatment as U.S. citizens or corporations.

Explanation of Provisions

Family attribution for characterization as a foreign personal holding company

The bill repeals, for the purpose of determining whether five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation, the rules that attribute ownership of stock actually owned by a nonresident alien to the alien's U.S. brothers and sisters (whether by the whole or half blood), ancestors, and lineal descendants. The bill will not affect the current attribution rules that operate to treat certain income from personal services and income from certain use of corporate property as foreign personal holding company income.

Income inclusion through foreign entity

The bill adds a tracing rule that makes it clear that taxpayers cannot interpose foreign corporations (other than foreign personal holding companies), foreign partnerships, estates or trusts whose gross income includes only income from sources within the United States, or other entities between themselves and the foreign corporation to avoid the foreign personal holding company rules. The bill provides that stock of a foreign personal holding company that is owned by a partnership, estate, or trust that is not a U.S. shareholder, or by a foreign corporation that is not a foreign personal holding company, will be considered (for income inclusion purposes) as being owned proportionately by its partners, beneficiaries, or shareholders. This rule will apply to trace ownership and attribute income through tiers of such entities. The bill grants regulatory authority to the Secretary of the Treasury to provide for such adjustments in the foreign personal holding company rules as may be necessary to carry out the purposes of this rule. Such an adjustment could be necessary, for example, to prevent double taxation of foreign personal holding company income.

This situation could arise in a case where a U.S. person owns shares in a foreign corporation which is not a foreign personal holding company which in turn owns stock in a foreign corporation that is a foreign personal holding company. Under the bill, the U.S. person could be subject to tax on his pro rata share of the income of the foreign personal holding company and, unless an adjustment were made, could be subject to tax again upon a dividend distribution from the same earnings from the foreign personal holding company which, in turn, is redistributed as a dividend by the foreign corporation to the U.S. shareholder. The committee intends that rules similar to those contained in section 959 apply.

Effective Date

The provisions will generally apply to taxable years of foreign corporations beginning after December 31, 1983. However, the rules relating to interposed foreign entities will apply to taxable years of foreign corporations beginning after December 31, 1984, with respect to certain stock of foreign corporations owned by certain pre-1954 trusts none of whose beneficiaries were U.S. citizens or residents at the time of creation or for ten years thereafter and that make only formal changes in their holdings after July 1, 1983.

Revenue Effect

These provisions will have a negligible revenue effect.

4. Ordinary Income Treatment on Disposition of Stock of Certain Foreign Corporations (sec. 454 of the bill and secs. 959 and 1248 of the Code)

Present Law

When a U.S. person sells or exchanges stock of a controlled foreign corporation (generally, a foreign corporation of which more than half of the combined voting power of all classes of stock entitled to vote is owned directly, indirectly, or constructively by U.S. persons who own 10 percent or more of that voting power), some of the gain may be taxed as ordinary income, not as a capital gain (Code sec. 1248(a)). The purpose of this rule is to deny capital gains treatment to income accumulated in foreign corporate solution that has not been taxed by the United States. The gain is ordinary (dividend) income rather than capital gain only to the extent of post-1962 earnings and profits (E&P) accumulated while the shareholder held the shares and that were not previously taxed by the United States.

The Internal Revenue Code also imposes tax at ordinary income rates in certain cases upon certain distributions by a domestic corporation, or the liquidation of a U.S. corporation, that owns stock of a controlled foreign corporation (sec. 1248(f)). This rule requires inclusion as a dividend in the income of the U.S. corporation an amount equal to the difference between the value of the domestic corporation's stock in the controlled foreign corporation and its adjusted basis in that stock to the extent of untaxed post-1962 E&P accumulated while the liquidating corporation held the shares.

Double counting.—If a U.S. person owns stock in a controlled foreign corporation and disposes of such stock at a gain to another U.S. person, the U.S. person's gain is recharacterized as dividend income in an amount equivalent to the accumulated E&P of the controlled foreign corporation, but the Internal Revenue Service took the position that such income inclusion does not reduce the E&P of the controlled foreign corporation by the amount of that income inclusion (Rev. Rul. 71-388, 1971-2 C.B. 314; *cf.* Rev. Rul. 83-182, 1983-51 I.R.B. (Dec. 19, 1983), suspending that ruling). That is, the taint of the previously untaxed E&P would remain even though the E&P has borne tax. A subsequent distribution by the controlled foreign corporation could therefore cause dividend treatment on account of E&P that had already caused a dividend inclusion. In addition, the new owner may take the position that it is entitled to foreign tax credits for taxes imposed on the controlled foreign corporation that the first owner (the selling corporation) has already credited. This double credit, if current law allows it, could reduce U.S. tax on other foreign income twice.

Similarly, when a U.S. corporation in a section 311, 336 or 337 transaction disposes of an interest in a controlled foreign corporation, it recognizes dividend income in an amount equivalent to the difference between the fair market value and its cost basis in the shares distributed, to the extent of the accumulated E&P of the controlled foreign corporation. It is not entirely clear whether the E&P of the controlled foreign corporation is reduced in the hands of the distributee. If the distributee receives a distribution from the controlled foreign corporation, it may be subject to tax at ordinary income rates on account of the E&P accumulated while the distributee owned the stock if E&P is not reduced. Taxpayers could attempt to credit the same taxes twice in this case also.

Indirect ownership.—Some taxpayers take the position that they may avoid ordinary income treatment on E&P of a controlled foreign corporation by a series of transactions between related parties. The first step in this series is the contribution of the stock in the corporation (a first-tier foreign subsidiary of a U.S. parent) to the capital of a second controlled foreign corporation (also a first-tier subsidiary of the U.S. parent). The second step is the sale or exchange of the stock of the second controlled foreign corporation (which now owns the first controlled foreign corporation). Taxpayers contend that the E&P that the first foreign corporation accumulated before the contribution of its stock to the second corporation is not subject to ordinary income treatment. They take the position that a cross-reference in the Code (sec. 1248(c)(2)(D)(ii)) indicates that E&P accumulated during direct ownership does not count when a U.S. person disposes of an interest held indirectly (as a second-tier subsidiary).

Reasons for Change

Section 1248 of the Code was intended to recapture at ordinary income rates the income of active foreign corporations the U.S. tax on which has been deferred. While the section has generally carried out this policy certain technical problems have come to the committee's attention. In one case the technical problem relates to the changes made in the Tax Reform Act of 1976, which generally closed unintended loopholes. The committee believes that the present law rules described above are unclear, at times possibly causing hardship in the form of a double tax and at times possibly giving taxpayers unintended benefits. The technical changes contained in the bill will clarify the operation of those rules. The committee is aware that the present rules are unclear, and intends no inference that they work as described.

Explanation of Provisions

Double counting.—The bill provides that to the extent that accumulated E&P has previously characterized income as ordinary income, that same E&P will not again characterize income as ordinary income. Therefore, if a a U.S. corporation owns stock in a controlled foreign corporation and that U.S. corporation liquidates, the dividend income generated on account of the accumulated E&P of the controlled foreign corporation will reduce the E&P of the controlled foreign corporation by the amount of that income inclusion. Similarly, if a U.S. person sells its interest in a controlled foreign corporation and recognizes dividend income on account of accumulated E&P, that income inclusion will, in effect, reduce the E&P of the controlled foreign corporation. The bill further clarifies present law to provide that, in any case, the new owner will not be entitled to foreign tax credits for taxes imposed on the controlled foreign corporation that the first owner had already credited.

Indirect ownership.—The bill clarifies current law to provide that E&P that a controlled foreign corporation accumulated while controlled by U.S. owners is subject to ordinary income treatment whether its U.S. owners controlled it directly or indirectly.

Effective Date

These provisions will each apply to sales or exchanges of stock of controlled foreign corporations that occur after the date of enactment. The double-counting provision will apply (upon an election) to transactions occurring after October 9, 1975 (the effective date of certain changes to Code section 1248). In the case of sales or exchanges of foreign corporate shares, the foreign corporation (or its successor in interest) is eligible to make the election. If a foreign corporation that would be eligible to make an election has been liquidated by the date of enactment or within the election period, its successors in interest shall be determined under rules similar to rules provided under section 964. In the case of a section 311, 336 or 337 transaction by a U.S. corporation that owns stock of a controlled foreign corporation, the distributing U.S. corporation or its successor is eligible to make the election. In either event, any election applies to all eligible post-October 9, 1975 transactions of the electing corporation. The corporation is to make the election within 180 days after enactment.

Revenue Effect

These provisions will have a negligible revenue effect.

5. Coordination of Subpart F with Foreign Personal Holding Company Provisions (sec. 455 of the bill and sec. 951 of the Code)

Present Law

Congress enacted the foreign personal holding company rules in 1937 to prevent U.S. taxpayers from accumulating investment income tax-free in foreign "incorporated pocketbooks." In 1962, Congress imposed tax on the U.S. shareholders of foreign corporations engaging in certain tax-haven type activities by adding the Subpart F rules to the Internal Revenue Code. The Subpart F rules, as amended, impose tax when a controlled foreign corporation has "Subpart F income," and in other circumstances.

Subpart F income includes income from related party sales and services transactions through tax haven-type base companies, from insurance of U.S. risks, from shipping operations (unless the income is reinvested), from foreign oil related activities, and from passive investments. Some of this income may also be taxable under the 1937 foreign personal holding company rules as amended. Subpart F imposes a tax (although not on "Subpart F income") in other circumstances, such as investment by a controlled foreign corporation of its earnings in U.S. property, and a controlled foreign corporation's withdrawal of its previously excluded income from shipping operations.

Where the foreign personal holding company rules and the Subpart F rules overlap, the foreign personal holding company rules generally take priority (sec. 951(d)). A taxpayer who is subject to tax under the foreign personal holding company rules may contend that it is not subject to the Subpart F rules that year. For instance, taxpayers (who are shareholders in a foreign corporation that is both a foreign personal holding company and a controlled foreign corporation) have taken the position that being subject to foreign personal holding company tax for a taxable year exempts them from taxation under Subpart F on investment that year in U.S. property of earnings of the foreign corporation. Because historical earnings invested in U.S. property, for example, might be substantially greater than current income taxed under the foreign personal holding company rules, such a position, if sustained, could undercut much of Subpart F. Courts have split on this issue. *Compare Whitlock* v. *Commissioner*, 494 F.2d 1297 (10th Cir. 1974), *cert. denied*, 419 U.S. 839 (holding the taxpayer liable for tax under Subpart F), *with Lovett* v. *United States*, 621 F.2d 1130 (Ct. Cl. 1980) (holding that no Subpart F tax was due).

Reasons for Change

The Code provision governing the overlap of Subpart F and the foreign personal holding company rules has produced uncertainty and some questionable results. The committee believes that U.S. taxpayers should be subject to tax on the full amount of the tainted earnings of their foreign corporations, not more and not less. However, no inference as to the proper result under present law is intended.

Explanation of Provision

The bill repeals the rule of section 951(d) that taxation under the foreign personal holding company rules precludes taxation under the Subpart F rules. It substitutes a new mechanism for the avoidance of double taxation by providing that a controlled foreign corporation's Subpart F income is taxed under Subpart F—but not under the foreign personal holding company rules—to the extent that it would otherwise be taxable under both Subpart F and the foreign personal holding company rules. Therefore, the existence of income subject to tax under the foreign personal holding company rules will not preclude taxation under Subpart F. Income includible under only one set of rules (foreign personal holding company rules or Subpart F rules) will be includible under that set of rules. A taxpayer taxable under Subpart F on amounts other than Subpart F income (on such items as withdrawals from foreign base company shipping income and investments in U.S. property) will be taxable under Subpart F whether or not its foreign corporation subjected it to foreign personal holding company tax.

Effective Date

This provision will apply to taxable years of U.S. shareholders beginning after the date of enactment.

Revenue Effect

This provision will result in a revenue gain of less than $5 million during each fiscal year during the period 1985-1989.

6. Stapled Stock (sec. 456 of the bill and new sec. 269B of the Code)

Present Law

Taxpayers have devised schemes for tax avoidance wherein the stock of two (or more) entities is "stapled" or "paired" so that a shareholder cannot trade the stock separately. Typically, however, the management of the two entities is the same.

Foreign corporations whose shares are sufficiently dispersed among U.S. persons are not subject to certain U.S. tax rules. The anti-tax-haven rules of Subpart F of the Code and the anti-international boycott rules apply to foreign corporations only if more than 50 percent of the total combined voting power of their stock is owned (directly or indirectly) by U.S. shareholders owning at least 10 percent of the stock each. The foreign personal holding company rules apply only if more than 50 percent of a corporation's outstanding stock (in value) is owned (directly or indirectly) by five or fewer U.S. shareholders. Widely held U.S. corporations have attempted to avoid these rules by splitting off their foreign operations and conducting them through separate corporations.

The stock of the foreign corporation is "stapled to" or "paired with" the stock of the original U.S. company so that a shareholder cannot buy or sell the stock of one corporation without buying or selling the stock of the other. Assuming the U.S. corporation, and thus the new foreign corporation, are sufficiently widely held, this device arguably reaches the result that the new foreign corporation is not subject to the subpart F and anti-boycott rules because the 10-percent shareholder test is not met. This device may similarly allow avoidance of the foreign personal holding company rules. It is not clear, however, that these split-offs have the tax consequences that these U.S. corporations seek. Although there is authority that would tend to support the integrity of these split-offs, see, e.g., Rev. Rul. 54-140, 1954-1 C.B. 116, other authority indicates that the courts will not respect the formation of such a "quasi-subsidiary." *De Coppet* v. *Helvering*, 105 F.2d 787 (2d Cir. 1940), *cert. denied*, 310 U.S. 646.

Stapling of stock of two or more U.S. corporations could allow shareholders to benefit from multiple surtax exemptions and from multiple accumulated earnings tax credits. In addition, one stapled entity may qualify for special tax treatment as a Real Estate Investment Trust (REIT) or a Regulated Investment Company (RIC). This special treatment would not be available if the operations of the companies were consolidated.

In these examples, and potentially in other cases where tax benefits among related parties are limited or where tax penalties may be imposed on related parties, companies may use stapled stock to appear to be unrelated.

Reasons for Change

The committee believes that the stapling of corporate stock is a simple means of attempting to avoid tax rules intended to limit abuse of the U.S. tax system or to limit the use of special tax benefits granted by Congress. Stapling of a taxable entity with a nontaxable entity is a particularly serious problem. In such a case, the shareholders (who are the same for both corporations) generally prefer profits, to be realized in the nontaxable entity rather than in the taxable entity. The committee believes that not to do something to preclude the use of such a transparent device would lead to disrespect for the tax system.

Transfer pricing.—Shareholders of stapled stock may have no business reason to complain if their taxable entity undercharges their nontaxable entity for goods or services.[30] If stock is not stapled, by contrast, the shareholders of a company can sue its management (in a shareholders' derivative suit) if it undercharges another entity. The United States has the right to correct improper transfer prices between related parties (sec. 482), but has found it difficult to do so in practice.[31]

The problem of transfer pricing arises on stapling of a special-purpose U.S. entity with another U.S. corporation. For instance, an ordinary corporation stapled to a Real Estate Investment Trust (REIT) that leases real property from the REIT may not object to a premium rental price, because the non-REIT's profits are subject to corporate tax while the REIT's are not. The problem of transfer pricing also arises on stapling of a U.S. corporation with a foreign corporation operating in a low-tax jurisdiction or in a tax haven.

Stapled foreign entities.—Stapling may also allow avoidance of the anti-tax-haven rules and the anti-boycott rules. Stapling can allow a U.S. company establishing foreign operations to avoid the U.S. corporate tax on dividends received from a subsidiary by establishing a stapled sister corporation rather than a subsidiary. Stapling a U.S. corporation with a foreign corporation could also raise issues of corporate opportunity. If either company could deal profitably with a new foreign customer or supplier, the shareholders may prefer that the foreign, nontaxable entity do so. The directors may not owe a duty to U.S. shareholders to seek business for the U.S. company.

Stapled U.S. entities.—The committee believes that stapling special purpose U.S. tax entities to ordinary U.S. entities threatens the policy that led Congress to create those special purpose U.S. tax entities. For example, Congress granted special tax status to corporations that qualify as REITs to allow small investors to invest in real estate. For that reason, REITs must concentrate their investments in real estate. If small investors buy shares in another corporation stapled to REIT shares, their investment in qualified real estate activities is diluted. Congress intended no such dilution when it enacted the REIT provisions.

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[30] If a U.S. corporation owns equal interests in a U.S. corporation and a nontaxed foreign corporation, it may prefer to have the next dollar of earnings go to the U.S. corporation (in which it owns stock) rather than the foreign corporation. If the effective U.S. tax rate (on the income of the corporation earning the marginal income) is low, the 85-percent dividends received deduction may outweigh the benefits of deferral for the U.S. corporate shareholder.

[31] See Comptroller General of the United States, Report to the Chairman, House Committee on Ways and Means, "IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations," September 30, 1981.

In addition, stapling arguably allows taxpayers multiple surtax exemptions and multiple accumulated earnings tax exemptions. The committee believes that such multiple exemptions are inappropriate.

Unusual circumstances.—The committee has taken notice of some unusual circumstances involving stapled stock. The committee believes that the United States should not tax a REIT stapled at the time of introduction of H.R. 3475 because the Internal Revenue Service, in several private letter rulings, explicitly sanctioned stapling of REITs. The committee also believes that the United States should not tax a stapled foreign corporation on income that was exempt from U.S. tax on income under a treaty at the time of introduction, because such taxation could violate the realistic expectations of our treaty partners. The committee also believes that the United States should not tax certain pre-existing stapled Puerto Rican corporations, because the possessions corporation rules (sec. 936) offer tax benefits comparable to those of stapling. The committee believes that all stapled entities should have adequate time to remove the requirement that shares trade in tandem, and that adequate time in the case of foreign stapled entities will typically be greater than adequate time in the case of domestic entities.

Explanation of Provision

The bill provides generally that where a foreign and a domestic corporation are stapled entities, the foreign corporation will be treated as domestic. Therefore, the stapled foreign corporation will be subject to U.S. tax on its worldwide income. The characterization of a foreign corporation as a U.S. corporation will not be subject to the rules of section 367, because distributions from the newly domestic corporation will be subject to U.S. tax.

If a foreign corporation and a U.S. corporation were stapled entities on June 30, 1983, the U.S. corporation may elect to be treated as owning all interests in the foreign corporation that constitute stapled interests with respect to stock of the U.S. corporation. To the extent that the stock of both companies is stapled, the U.S. corporation will, upon this election, be subject to tax on certain income of the foreign corporation, including its Subpart F income, if any. Also, if some of the stock of the foreign corporation (1) is not stapled to stock of the U.S. corporation and (2) belongs to non-U.S. shareholders, then (after an election to treat the foreign corporation as a foreign subsidiary of the U.S. corporation) earnings attributable to that stock or dividends to a foreign shareholder will not generally be subject to current U.S. tax. An election to treat a foreign corporation as a foreign subsidiary of a U.S. corporation must be made not later than 180 days after the date of enactment, and in such manner as the Secretary or his delegate shall prescribe. This election will be revocable only with the consent of the Secretary or his delegate.

The stapled stock provision generally overrides treaties. However, the bill will not restrict treaty benefits in the case of entities stapled on June 30, 1983, to which those entities were entitled on that date, so long as those entities remain entitled to those benefits under the applicable treaty. If treaties are renegotiated to eliminate benefits for stapled companies (a result that would be consistent with the committee's intent), stapled companies would lose current treaty benefits. For example, the bill provides that a foreign corporation stapled to a U.S. corporation is taxable as a U.S. corporation. A treaty may provide, for example, that a corporation incorporated under the laws of the treaty partner is not taxable in the United States on industrial or commercial profits unless it has a U.S. permanent establishment (see, e.g., Article III(1) of the U.S.-Netherlands Income Tax Treaty). In such a case, a foreign corporation stapled on June 30, 1983 to a U.S. corporation will be entitled to applicable treaty benefits.

Stock in one corporation which constitutes a stapled interest with respect to stock of a second corporation will generally be treated as owned by the second corporation for purposes of Code section 1563; the effects of this section 1563 treatment include denial of multiple surtax exemptions and denial of multiple accumulated earnings tax credits. All stapled entities will generally be treated as one in determining whether any one is a REIT or RIC. These rules will be subject to modification by the Secretary of the Treasury by regulation. In addition, the Secretary of the Treasury is to prescribe such regulations as will be necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities. Such regulations would include, but will not be limited to, regulations providing the extent to which one stapled entity will be treated as owning another stapled entity (to the extent of the stapled interest).

Under the standard rules governing consolidated returns, stapled U.S. corporations generally will not be eligible to file consolidated returns. Under the same rules, a foreign corporation that is stapled to a U.S. corporation will not be eligible to file a consolidated return with its U.S. sister (whether or not an election to treat the foreign sister as owned by the U.S. company to the extent of the stapling is in effect). A contiguous country stapled corporation described in section 1504(d) might be eligible to consolidate under the regular rules, however. The bill defines the term "entity" to mean any corporation, partnership, trust, association, estate, or other form of carrying on a business or activity. The bill defines the term "stapled entities" to mean any group of two or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consisted of stapled interests. Two or more interests will be stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of one of such interests the other such interests will be also transferred or will be required to be transferred.

For example, assume that two U.S. citizens each own 50 percent of a U.S. corporation and a foreign corporation. Under two separate standard death redemption agreements, the corporation agrees to buy, and each shareholder obligates his estate to sell, all of the shares of the first shareholder to die. These shares are not stapled for purposes of the bill, so long as each shareholder may trade shares of the two corporations freely before death.

Again assume that two U.S. citizens each own 50 percent of a U.S. corporation and a foreign corporation. Under two separate standard right of first refusal agreements, neither shareholder may sell or exchange any of the shares of either corporation without allowing the other shareholder (or, alternatively, the corporation) the right to match the price offered for his or her shares. These shares are not stapled for the purpose of the bill, so long as either shareholder may dispose of his interest in one corporation without disposing of his interest in the other.

The bill would not apply to U.S. corporations stapled to Puerto Rican corporations as of June 30, 1983 if the Puerto Rican corporation is described in section 957(c) of the Code (or would be described in that subsection if dividends from section 957(c) corporations were income described in section 957(c)), and if it does not own stock in any corporation that is not described in section 957(c). To qualify for this treatment, the stapled Puerto Rican corporation must also meet the activity test of section 957 (c)(2).

Effective Date

In general, this provision will take effect on the date of enactment of the bill. However, for interests stapled on or before June 30, 1983, the amendment will not apply until January 1, 1985. In addition, the bill will not apply to foreign corporations stapled to U.S. corporations on June 30, 1983, until January 1, 1987. A group of stapled. entities that included a REIT on June 30, 1983, will not be subject to the rules of the bill if all members of the group were stapled on that date.

Revenue Effect

The provision will increase budget receipts by less than $5 million annually.

F. Miscellaneous Treasury Administrative Provisions

1. Simplification of Certain Reporting Requirements (sec. 461 of the bill)

Present Law

The Department of the Treasury is required to report to the Congress regarding specific statutory provisions on an annual or other periodic basis. The provisions affected by the bill are discussed below.

DISC.—The Treasury Department is required by statute to submit an annual report on the Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code.[32] This report is due 15½ months after the end of each calendar year.

International boycotts.—The Treasury Department is required by statute to submit an annual report on the international boycott provisions of the Internal Revenue Code.[33] This report is to set forth the number of boycott reports filed for taxable years ending with or within that year, the number of such reports on which the taxpayer indicated boycott participation or cooperation, and a detailed description of the manner in which the boycott provisions of the Code have been administered during that calendar year. The Secretary is to transmit this report as soon after the close of each calendar year as the data become available.

Possessions corporations.—The committee reports on the Tax Reform Act of 1976 require an annual report to the House Committee on Ways and Means and the Senate Committee on Finance on possessions corporations. The committee reports stated that "The Treasury is to submit an annual report . . . setting forth an analysis of the operation and effect of the possessions corporation system of taxation. Among other things, the report is to include an analysis of the revenue effects of the provision as well as the effects on investment and employment in the possessions." [34] The committee reports indicated that these annual reports are to be submitted within 18 months following the close of each calendar year.

High income taxpayers.—The Tax Reform Act of 1976 requires the Department of the Treasury to publish information annually on the amount of tax paid by individual taxpayers with high total incomes.[35] The statute presently requires calculation of total income in the following three ways: (1) adjusted gross income (AGI) plus tax preference items (which are exclusions from gross income or deductions in arriving at AGI), (2) AGI less investment interest and expense (to the extent that it does not exceed investment income), and (3) AGI with both of these modifications. The statute also requires publication of the number of individuals with total incomes of over $200,000 who owe no Federal income tax and the deductions, exclusions, or credits they used to avoid tax.

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[32] Sec. 506 of the Revenue Act of 1971, Public Law 92-178, imposes this requirement.

[33] Sec. 1067 of the Tax Reform Act of 1976, Public Law 94-455, imposes this requirement.

[34] H. Rep. No. 94-658, 94th Cong., 1st Sess. 259; S. Rep. No. 94-938, 94th Cong., 2d Sess. 282.

[35] Sec. 2123 of the Tax Reform Act of 1976, Public Law 94-455, imposes this requirement.

Reasons for Change

The committee believes that the Treasury reporting requirements can be lessened without diminishing the usefulness of information supplied in the reports. The committee understands that the Treasury will make current the statistics of income reports relating to foreign income.

Explanation of Provision

The bill modifies several of the statutory Treasury Department reporting requirements.

DISC.—The Secretary of the Treasury will be required to submit a report setting forth an analysis of the operation and effect of the DISC provisions for calendar 1981 and for each second calendar year thereafter. The DISC report will be due 27½ months following the close of each such second year.

International boycotts.—The bill requires the Secretary to submit an international boycott report for every four-year period. The first four-year period will begin with calendar year 1982. The data required would be the data required under current law, for a four-year period rather than a one-year period. The report will be due as soon after the close of each four-year period as the data become available.

Possessions corporations.—The Secretary will be required to submit a report setting forth an analysis of the operation and effect of the possessions corporations provisions for calendar 1981 and for each second calendar year thereafter. The possessions corporations report will be due 24 months following the close of each such second year.

High income taxpayers.—The bill requires the Secretary of the Treasury to publish information annually on the amount of tax paid by individual taxpayers with high total incomes. Total income could be calculated and set forth by adding to adjusted gross income any tax preference items excluded from or deducted in arriving at AGI, and by subtracting any investment expenses incurred in the production of such income to the extent of the investment income. The bill also requires publication of the number of individuals with total incomes of over $200,000 who owe no Federal income tax and the deductions, exclusions, or credits that they used to avoid tax.

Effective Dates

The new rule for DISC reports and possessions reports applies to reports for calendar years after 1980. The new rule for high income taxpayer reports applies to information published after the date of enactment. The new rule for international boycott reports applies to reports for periods after December 31, 1981.

Revenue Effect

This provision will have a negligible revenue effect.

2. Removal of $1 Million Limitation on Working Capital Fund (sec. 462 of the bill and sec. 322(a) of Title 31)

Present Law

Under present law, the Treasury Department's Working Capital Fund provides for the financing of centralized, Department-wide services such as printing procurement, reproduction, telephone, and teletype functions (31 U.S.C. 322(a)). The fund is limited to a capitalization of $1 million. This limitation was set in 1970 when the Fund was established.

Reasons for Change

The committee believes the ceiling on the Working Capital Fund is unnecessary and should be removed.

Explanation of Provision

Under the bill, the $1 million limit on the Working Capital Fund of the Department of Treasury is removed.

Effective Date

This provision will be effective upon enactment of the bill.

Revenue Effect

This provision will have a negligible revenue effect.

3. Increase in Limitation on Revolving Fund for Redemption of Real Property (sec. 463 of the bill and sec. 7810 of the Code)

Present Law

Under present law, if real property on which the United States has or claims a lien is sold to satisfy a lien prior to that of the United States, the Internal Revenue Service may redeem the property generally within 120 days of the sale date (sec. 7425). This redemption right is exercised, however, only when the Service concludes that the sale price of such real property is significantly below the fair market value and if the sale price does not provide sufficient receipts to cover the government's lien.

All expenses necessary for the redemption by the Service of such real property are chargeable to a revolving fund. The fund is repaid upon a subsequent sale of the property. Under present law, the authorization for this fund may not exceed $1 million. This figure was established in 1966. Because of increases in the numbers of taxpayer delinquencies, escalating real property values, and a greater frequency in foreclosures, the present $1 million authorization for the revolving fund is insufficient to provide for all those cases where redemption of real property sold to satisfy a lien prior to that of the United States would be prudent.

Reason for Change

The committee believes that the monetary interests of the United States would be better protected if additional funds were authorized for the revolving fund for the redemption of property.

Explanation of Provision

The authorization limitation on the real property redemption revolving fund will be increased to $10 million.

Effective Date

The provision will be effective upon enactment of the bill.

Revenue Effect

This provision will not have a direct revenue effect. If pursuant to the increased authorization, additional funds are appropriated for the revolving fund and redemption rights are exercised more frequently, revenues could be increased.

4. Removal of $1,000,000 Limitation on Authority to Dispose of Obligations (sec. 464 of the bill and sec. 324(b) of Title 31)

Present Law

Under present law, the Secretary of the Treasury has special authority, outside of the context of the Federal Property and Administrative Services Act of 1949, to dispose of obligations acquired by the Secretary for the United States or transferred to the Secretary by an executive agency. The Secretary may also make arrangements to extend the maturity of such obligations. The Secretary is authorized to dispose or extend the maturity of obligations "in the way, in amounts, at prices, and on conditions the Secretary considers advisable and in the public interest."

The provision was enacted in 1945, as part of the Public Debt Act of 1945. It was designed, among other things, to allow for the expeditious disposition of obligations without the market disruption and loss that might be attendant on lengthy disposal procedures, including a three-month advertising requirement then applicable. Since its enactment in 1945, it has contained a limitation of $1,000,000 on the maximum par value of obligations of one issuer that could be held for such disposition. If no-par obligations are involved, the $1,000,000 limitation applies to the stated or book value of such obligations.

Reasons for Change

Because of inflation and changes in the capitalization of entities in which the United States has acquired an interest, the committee believes that the $1 million limitation is no longer appropriate. It has restricted the ability of the Secretary to obtain the best value for the United States in disposition transactions.

Explanation of Provision

The bill repeals the $1,000,000 limitation of the Secretary's special authority to dispose of obligations.

Effective Date

The provision will be effective on date of enactment.

Revenue Effect

The provision will have a negligible revenue effect.

5. Secretary of Treasury Authorized to Accept Gifts and Bequests (sec. 465 of the bill and sec. 322(a) of Title 31)

Present Law

At present, the Treasury Department has authority to accept voluntary services in connection with the sale of public debt obligations (31 U.S.C. 21). Also, the Department has joint authority with the General Services Administration to accept gifts for the purpose of reducing the national debt (31 U.S.C. 3113) and for defense purposes (50 U.S.C. 1151). However, the Secretary of the Treasury does not have general authority to accept gifts and bequests on a department-wide basis to carry out departmental functions. The Comptroller General has ruled that agencies may not accept gifts and bequests for assisting them in carrying out governmental functions in the absence of specific authorization (36 Comp. Gen. 268). At present, there are numerous statutes authorizing various agencies to accept gifts in connection with their operations, *e.g.*, the Department of Commerce (15 U.S.C. 1522), the Department of Transportation (49 U.S.C. 1657 (m)), and the Department of Housing and Urban Development (42 U.S.C. 3535(k)). In addition, department-wide gift authority is possessed by the Departments of Agriculture and State and numerous other agencies for the conduct of agency activities.

Reasons for Change

The committee believes that the Treasury Department should be authorized to accept departmental gifts in the same way as other departments are authorized.

Explanation of Provision

The bill authorizes the Secretary of the Treasury to accept gifts and bequests of property for the purpose of aiding or facilitating the work of the Department of Treasury. Gifts and bequests of money and the proceeds from sales of other property so received will be deposited in a separate fund of the Treasury to be disbursed upon the Secretary's order.

The Secretary annually must publicly disclose the source of the gifts and bequests and the purposes for which any expenditures are made.

Effective Date

The provision will be effective upon enactment.

Revenue Effect

The provision will have a negligible revenue effect.

6. Extension of time for Court Review of Jeopardy Assessment Where Prompt Service Not Made on United States (sec. 466 of the bill and sec. 7429 of the Code)

Present Law

Generally, the Internal Revenue Service may not assess any income tax without sending a written notice of deficiency allowing the taxpayer 90 days in which to petition the Tax Court for review of the Service's determination.

No assessment may be made until after the 90-day period has expired or, if a petition is filed, until after a decision of the Tax Court is final.

These deficiency procedures need not be followed, however, when the I.R.S. reasonably believes that collection of an alleged deficiency would be jeopardized by delay. In such a case, the Service may immediately assess and collect the tax (secs. 6851 and 6861).

In jeopardy assessment cases, the taxpayer is entitled to an expedited review by the Secretary, through the district director, of whether the determination of jeopardy was reasonable under the circumstances and whether the amount assessed and demanded was appropriate under the circumstances (sec. 7429). After review by the district director, the taxpayer is also entitled to a review by the appropriate United States District Court. Under present law, the District Court must decide whether the determination of jeopardy was reasonable under the circumstances and whether amount of the assessment was appropriate under the circumstances. This decision must be made within 20 days after an action by a taxpayer for review of the Secretary's determination is commenced. This action is a suit against the United States and, therefore, requires that the United States be given notice. However, neither the applicable statute (sec. 7429) nor the Federal Rules of Civil Procedure require service of notice of the action to be served on the United States within the 20-day period.

Reasons for Change

The committee wishes to assure adequate time for the United States to respond before a decision must be entered in any suit brought by a taxpayer for a review of a jeopardy action.

Explanation of Provision

Under the bill, if the District Court determines that proper service was not made on the United States within 5 days of the date on which the action is commenced, the 20-day period for action by the District Court will not begin to run until the day proper service was made on the United States.

Effective Date

This provision will apply to actions commenced after the date of enactment.

Revenue Effect

The provision will have a negligible revenue effect.

7. Extension of Period to Assess Unpaid Taxes (sec. 467 of the bill and sec. 6501 of the Code)

Present Law

Present law generally limits the period for assessing taxes to three years beginning with the date the return is filed or the due date of the return, whichever is later. This general rule is modified for fraudulent returns, returns involving a substantial omission of income and in several other appropriate circumstances. There is no provision, however, which permits extending the period for assessment solely for purposes of processing an amendment to an original return and assessing additional taxes due.

Reason for Change

Under present law it is very difficult for the Internal Revenue Service to assess additional tax reported on amended returns filed on, or just prior to, the expiration of the period for assessment of taxes on the original return. The committee's bill therefore extends the time for assessment of amounts shown on certain amended returns.

Explanation of Provision

Section 6501 is amended to provide that if a taxpayer amends an original return to show an increase in tax liability within 60 days of the expiration of the period for assessment of tax, the period for assessment will be extended solely to allow the IRS 60 days from the date the amendment is received to process the amendment and assess the additional tax shown thereon. This change will assure that additional tax due as reported by a taxpayer on an amended return may be assessed and collected.

Effective Date

The provision is effective for amended returns received after date of enactment of the bill.

Revenue Effect

This provision will increase revenues by less than $5 million annually.

8. Lien on Assets of Financial Institutions for Unpaid Drafts (sec. 468 of the bill and sec. 6311(d) of the Code)

Present Law

Under present law (sec. 6311(b)(2)), if a certified, treasurer's or cashier's check received in payment of taxes is not duly paid, the United States has a lien upon all assets of the bank or trust company on which drawn. This rule also provides a lien against the assets of the issuer of a money order. The lien is a preferred claim and consequently permits the Service to treat such payments as the equivalent of cash for the purposes of releasing a Federal tax lien encumbering a taxpayer's property. The taxpayer retains ultimate liability if the IRS is unable to collect from the bank or trust company.

Reasons for Change

There have been many changes in the activities of financial institutions during the past few years. Mutual savings banks, credit unions and savings and loan associations generally provide checking account services that were not anticipated when the provisions of present law were enacted. In addition, these institutions may certify checks and issue instruments that are viewed by the general public as equivalent to the traditional cashier's check issued by a commercial bank, and should be so treated for purposes of collecting from the issuers.

Explanation of Provision

The bill extends the provision of section 6311(b)(2) to include guaranteed drafts of financial institutions other than banks and trust companies. It is expected that the regulations issued under this provision would define "financial institution" to include domestic building and loan associations, mutual savings banks, and credit unions.

Effective Date

This provision will be effective upon date of enactment.

Revenue Effect

This provision will have a negligible revenue effect.

9. Disclosure of Windfall Profit Tax to State Tax Agencies (sec. 469 of the bill and sec. 6103(d) of the Code)

Present Law

Present law (sec. 6103(d)(1)) authorizes the disclosure of returns and return information with respect to taxes imposed by chapters 1, 2, 6, 11, 12, 21, 23, 24, 31, 32, 44, 51, and 52 and subchapter D of chapter 36 to the State tax agencies which are principally charged with the primary responsibility for the administration of State tax laws. Present law does not authorize the Service to disclose windfall profit tax (chapter 45) information to State tax agencies.

Reasons for Change

The provision will provide States with a means of verifying information reported by oil producers and purchasers, in compliance with State severance tax laws, with information provided by the producers and purchasers to the Internal Revenue Service with respect to the windfall profit tax.

Explanation of Provision

The bill adds the windfall profit tax to the list of tax returns and return information which the Internal Revenue Service may disclose to State tax agencies for purposes of administering State tax laws.

Effective Date

This provision will be effective on date of enactment.

Revenue Effect

This provision will have no revenue effect.

10. Provisions Relating to Distilled Spirits

a. Repeal of occupational tax on manufacturers of stills and condensers (sec. 470 of the bill and secs. 5101, 5105 and 5179 of the Code)

Present Law

Present law (sec. 5101) imposes an occupational tax of $55 per year on manufacturers of stills. In addition, a tax of $22 is imposed on each still (or condenser to be used in distilling) manufactured. An exemption from these taxes is provided for stills manufactured by a proprietor of a distilled spirits plant exclusively for use in the proprietor's plant.

Under present law, a manufacturer of stills is required to notify the Treasury Department, in writing, of the removal of a still, boiler, or other distilling vessel from the place of manufacture and the person and place to which it is being delivered (sec. 5105). The still (or other distilling apparatus) may be set up only upon receipt of a written permit from the Treasury. Further, every person having possession or control over a still is required to register with the Treasury immediately after setting up the still (sec. 5179). The registration must set forth the name and address of the owner and the location, capacity and purpose of the still.

Reasons for Change

The costs to administer the taxes on still manufacturers substantially outweigh the revenues derived from these taxes (less than $10,000 per year). The bill therefore repeals these taxes.

The committee has considered the notice requirement for removal of stills and other distilling apparatus and believes that this requirement serves a valid administrative purpose relating to the collection of alcohol taxes generally. However, in recognition of the costs to both the Treasury and private businesses of administering these provisions, the committee believes that the Treasury should be entitled to apply this requirement at its own discretion. Accordingly, the bill replaces the existing statutory notice requirement with a provision allowing the Treasury to require notice pursuant to regulations.

The committee understands that, because the excise tax liability for distilled spirits attaches upon production, the Treasury must be aware of the location of stills and other distilling apparatus in order to properly administer these taxes. The committee has therefore retained the mandatory requirement of registration immediately after setting up a still.

Explanation of Provision

The bill repeals both the $55 per year occupational tax on manufacturers of stills and the additional $22 tax for each still.

The bill repeals the mandatory requirement of notice of manufacture and removal of a still and the requirement of permission prior to set up of a still. In their place, the bill provides that the Treasury Department may, pursuant to regulations, require manufacturers of stills, boilers, or other distilling vessels to give notice before removal of the facility. This notice (if required) would set forth the capacity of the facility, the time of removal, and the person by whom the facility is to be used. However, the bill retains the requirement of registration by the still user after setting up the facility.

Effective Date

The provision is effective on the first day of the first month beginning more than 90 days after the date of enactment.

Revenue Effect

This provision will have a negligible revenue effect.

b. Return of taxes on spirits used for food or medicinal purposes (sec. 471 of the bill and sec. 5134 of the Code)

Present Law

Present law imposes an excise tax of $10.50 per proof gallon of distilled spirits (sec. 5001). The law provides for the return (drawback) of the major portion of taxes on distilled spirits used in the manufacture of food products, flavorings, or medicines which are unfit for beverage purposes (sec. 5134). A drawback is claimed by submission of a properly executed claim by a qualifying user of the spirits.

Taxpayers claiming a drawback of distilled spirits taxes are required to keep the necessary books and records to establish that the spirits were used for food, medicinal or other nonbeverage purposes (sec. 5132). Treasury regulations require that supporting data be maintained by the manufacturer, including quantitative formulae which must be filed prior to or at the time of manufacture (27 CFR Part 197.95). Failure to comply with these requirements results in a denial of the claim. For example, any deviation from a previously filed formula may result in denial of a substantial drawback claim.

Reasons for Change

The committee believes that failure to comply with various technical aspects of the drawback provisions should not result in denial of the taxpayer's claim. Accordingly, the bill provides that a penalty be imposed for such violations, in lieu of denying the claim. This is consistent with the treatment of other nonfraudulent regulatory violations under the Internal Revenue Code.

Explanation of Provision

The bill provides that the Treasury Department shall not deny a drawback claim because of failure to comply with laws or regulations, if it is established to the Department's satisfaction that the distilled spirits have been used for food, medicinal or other nonbeverage purposes. In lieu of denial, the claimant will be liable for a $1,000 penalty for each failure to comply with the applicable laws or regulations (unless it is shown that the failure was due to reasonable cause). The aggregate amount of the penalties may not exceed the amount of the taxpayer's claim.

The committee intends that, if nonbeverage products deviate from previously filed formulas, the determination of a failure to comply with the regulations would be made with respect to each separate product reflected in a drawback claim. For example, if a manufacturer of two distinct flavors or extracts were to submit a drawback claim, and some portion of each flavor deviated from the previously filed formula, the claimant would be liable for a penalty of $2,000 (unless the failure to comply was due to reasonable cause).

Effective Date

The provision is effective on the first day of the first calendar month beginning more than 90 days after the date of enactment.

Revenue Effect

This provision will reduce revenues by less than $1 million annually.

c. Disclosure of alcohol fuel producers to administrators of State alcohol laws (sec. 472 of the bill and sec. 6103 of the Code)

Present Law

Present law (sec. 6103) prohibits the Treasury Department from disclosing individual tax return information (including the identity of taxpayers), without the taxpayer's consent, except under certain specified circumstances. In general, disclosure is permitted where necessary for the enforcement or administration of the tax laws (including tax legislation), in connection with criminal investigations, and in certain cases including an overriding public policy interest (e.g., disclosure to state child support enforcement agencies). Disclosure may also be made to other Federal agencies for certain specified purposes.

Under present law (sec. 6103(d)), tax return information may be disclosed to State agencies charged with responsibility for administration of State tax laws. Such disclosure may be only to the extent necessary for the administration of State tax laws.

The names and addresses of distillers who produce alcohol for fuel use qualify as tax return information under present law. Accordingly, this information may be disclosed only under the circumstances specified by the Code (e.g., to State tax agencies).

Reasons for Change

The committee believes that disclosure of the identity of alcohol fuel producers will be useful to State governments in monitoring the production of alcohol fuels. Such disclosure is consistent with the general Federal policy of encouraging the development and use of these fuels. However, the committee believes that this disclosure should be subject to reasonable safeguards to preserve the confidentiality of the information.

Explanation of Provision

The bill allows the Treasury Department to disclose the names, addresses, and business locations of persons producing alcohol for fuel use to State agencies (or their legal representatives) charged with responsibility for the administration of State alcohol laws. The information is to be disclosed solely for use in the administration of State alcohol laws.

The disclosure allowed by the bill is subject to the safeguards established by present law (sec. 6103(p)(4)) for disclosure to other Federal and State agencies. These safeguards are designed to preserve the confidentiality of information once it has been provided to another agency.[36]

Effective Date

The provision is effective on the first day of the first calendar month beginning more than 90 days after the date of enactment.

Revenue Effect

The provision will have no revenue effect.

d. Elimination of Government-supplied strip stamps for distilled spirits containers (sec. 473 of the bill and secs. 5205, 5604, and new sec. 5301(d) of the Code)

Present Law

Present law (sec. 5205) requires distilled spirits containers transported or sold in the United States to bear a stamp indicating that the Federal excise tax on the spirits has been paid. Strip stamps which satisfy this requirement are printed by the Bureau of Engraving and Printing at an estimated cost of $1.7 million per year and are distributed to distillers and bottlers free of charge.[37] Although regulations first effective in 1980[38] authorize the use of alternate methods of indicating payment of tax, most distillers have continued to use the Government-supplied strip stamps on distilled spirits containers.

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[36] Sec. 6103(p)(4) requires, *inter alia*, that an agency receiving return information must (1) establish and maintain a permanent system of standardized records with respect to requests for information made or received by the agency, (2) restrict access to tax return information to those who require it, and (3) provide such other safeguards as Treasury may deem appropriate. The agency is further required to report to the Treasury concerning its procedures for preserving confidentiality.

[37] U.S. General Accounting Office, "The Federal Government Can Save $1.7 Million Annually by Eliminating Strip Stamps" (GAO Report GGD-82-60, May 7, 1982).

[38] 27 CFR Part 19.663.

Government-supplied strip stamps must generally be broken in order to open a distilled spirits container. Thus, the stamps act as closure devices for the containers.

For many years, strip stamps were numbered and generally controlled by employees of the Treasury Department's Bureau of Alcohol, Tobacco, and Firearms. The stamps were applied after these employees had determined the appropriate tax and had been satisfied that the spirits had been bottled in conformance with Federal laws. However, the Distilled Spirits Tax Revision Act of 1979 (P.L. 96-39) significantly modified the determination of tax on distilled spirits. The new method of determining tax when spirits are withdrawn from bond eliminated the need for Federal employees to be present at distilled spirits plants to regulate operations and to determine the tax before bottling. Consequently, strip stamps are now provided to distillers and, in most cases, are placed on distilled spirits containers before the tax has been determined.

Reasons for Change

The committee understands that, pursuant to the Distilled Spirits Tax Revision Act of 1979, the Treasury Department is eliminating regular on-site supervision of distilled spirits plants and concentrating its effort on an audit-based approach to tax compliance. The committee further understands that, because strip stamps are now generally placed on distilled spirits containers before the tax is determined, the stamps no longer provide evidence of payment of the tax. For these reasons, and because of the costs of supplying the stamps, the bill provides that government-supplied strip stamps will be eliminated. However, to prevent tampering with the contents of distilled spirits containers, the committee bill requires that alternate closure devices be used.

Explanation of Provision

The bill repeals the strip stamp requirement for distilled spirits containers (sec. 5205) and associated penalty provisions (sec. 5604). However, the bill requires that distilled spirits containers, on determination of tax, bear a closure or other device which is designed to require breaking in order to gain access to the contents of the container (new sec. 5301(d)). The provision applies to domestically produced and imported distilled spirits. Closure devices are not required for containers having a capacity in excess of one wine gallon.

The committee intends that government-supplied strip stamps may be affixed to containers of distilled spirits only until July 1, 1985. However, in cases where strip stamps are affixed to containers of distilled spirits before that date, the containers may be imported or brought into the United States, released from Customs custody, or withdrawn from internal revenue bond with the stamps affixed. In such cases, the committee intends that the Federal strip stamp on such containers be considered to meet the bill's requirement for an antitampering device on distilled spirits containers.

Effective Date

These provisions are effective on July 1, 1985.

Revenue Effect

The provision will have no effect on budget receipts. However, the elimination of strip stamps will save the Federal Government an estimated $1.7 million per year in printing costs.

G. Tax Court Provisions

1. Small Tax Cases (sec. 475 of the bill and sec. 7463 of the Code)

Present Law

Under present law, taxpayers using the "small tax case" procedure may appear pro se or be represented by any person admitted to practice before the Tax Court. In general, small tax cases are cases involving $5,000 or less for any one taxable year or period. Such proceedings are generally conducted in a more informal atmosphere, and the Court's opinion is final and may not be appealed.

Reasons for Change

The committee believes that Tax Court cases can be handled more expeditiously if the dollar limit on the cases in which the taxpayer may elect the small tax case procedures is raised, and if taxpayer representation in those cases is expanded.

Explanation of Provision

The bill permits taxpayers to be represented in the Tax Court in small tax cases by certified public accountants and enrolled agents who are authorized to practice before the I.R.S., regardless of whether such persons have been admitted to practice before the Tax Court by passing the Court's examination.

The bill raises the dollar limit in small tax cases to $10,000.

Effective Date

The provision will be effective on the date of enactment of the bill.

2. Survivor Annuities (sec. 476 of the bill and sec. 7448 of the Code)

Present Law

Under the survivors annuity plan for Tax Court judges, if a judge is survived by a spouse and a dependent child or children, an annuity equal to one-half the annuity of the surviving spouse (but not to exceed the lesser of $900 per year divided by the number of such children or $360 per year) is payable to each child. If a judge leaves no surviving spouse, but leaves a surviving dependent child or children, the annuity payable to each child is equal to the annuity to which a surviving spouse would have been entitled, but not to exceed $480 per year.

These maximum annuity amounts have not been changed since 1961, although the limits for annuities to surviving children of other Federal judges have been increased.

Reasons for Change

The committee believes that the annuities for surviving children of Tax Court judges should be increased to reflect cost of living changes since the limits were set.

Explanation of Provision

Under the bill, the maximum annuities receivable by surviving children of a deceased Tax Court judge in the case where the judge also leaves a surviving spouse will be increased from $900 per year per family ($360 per child) to $4,644 per year per family ($1,548 per child). The comparable amounts for surviving dependent children where the judge leaves no surviving spouse will also be increased to a maximum annuity not in excess of $5,580 per year per family, or $1,860 per child, whichever is less.

These maximum limits are equal to those currently in effect for other Federal judges.

Effective Date

These provisions will be effective for annuities payable for months after the date of enactment of the bill.

3. Assignment of Proceedings (sec. 477 of the bill and sec. 7456 of the Code)

Present Law

Present law (sec. 7456 (d)) provides that the Chief Judge of the Tax Court may assign to the Court's commissioners for hearing and decision any declaratory judgment proceeding, any small tax case proceeding, and any other proceeding where the amount in dispute does not exceed $5,000, subject to such review as the Court may provide.

Reasons for Change

The committee wishes to clarify that additional proceedings may be assigned to Commissioners so long as a Tax Court judge must enter the decision.

Explanation of Provision

A technical change is made to allow the Chief Judge of the Tax Court to assign any proceeding to a special trial judge for hearing and to write proposed opinions, subject to review and final decision by a Tax Court judge, regardless of the amount in issue. However, special trial judges will not be authorized to enter decisions in this latter category of cases.

Effective Date

The provision will be effective as if enacted as part of the Miscellaneous Revenue Act of 1982.

4. Special Trial Judges (sec. 478 of the bill and sec. 7456 of the Code)

Present Law

The Chief Judge of the Tax Court is authorized to appoint commissioners to hear small tax cases and declaratory judgment actions. The commissioners must proceed under rules promulgated by the Court.

Reasons for Change

The committee believes that the title of the commissioners should be changed to "special trial judge", to better describe their job position.

Explanation of Provision

The title of Tax Court commissioner will be changed to "special trial judge."

Effective Date

The provision will be effective on the date of enactment of the bill.

5. Publicity of Tax Court Proceedings (sec. 479 of the bill and sec. 7461 of the Code)

Present Law

All reports of the Tax Court and all evidence received by the Court are open to public inspection, except that after its decision in a case has become final, the Court may permit the withdrawal of documents from the record or make such other disposition thereof as it deems advisable.

Rule 103(a) of the Tax Court's Rules of Practice and Procedure provides that the Court may make any order which justice requires to protect a party or other person from annoyance, embarrassment, oppression, or undue burden or expense, including an order requiring that a deposition or other written materials be placed under seal, that a trade secret or other information not be disclosed or be disclosed only in a designated way, or that documents or information be filed in sealed envelopes to be opened only as directed by the Court.

Reasons for Change

The committee wishes to clarify that the Tax Court may prevent disclosure of confidential information.

Explanation of Provision

The bill clarifies that the Tax Court may take any action necessary to prevent the disclosure of trade secrets and other confidential information.

Effective Date

The provision will take effect on the date of enactment of the bill.

6. Retirement Age for Tax Court Judges (sec. 480 of the bill and sec. 7447(b) of the Code)

Present Law

Under present law, Tax Court judges must retire upon attaining the age of 70 years.

Reasons for Change

The committee believes that Tax Court judges should be subject to the same Federal policy regarding mandatory requirement as other Federal employees, and thus should not be required to retire upon attaining age 70.

Explanation of Provision

The bill provides that Tax Court judges will no longer be required to retire upon attaining age 70, but instead may retire at any time after attaining age 70.

Effective Date

The provision will become effective on date of enactment of the bill.

7. Revenue Effect

The provisions relating to the Tax Court will not have a revenue effect.

H. Simplification of Income Tax Credits (secs. 481-486 of the bill and new secs. 21-53 of the Code)

Present Law

Present law provides a series of nonrefundable income tax credits which are allowable to reduce a taxpayer's tax liability. The credits have been added to the Internal Revenue Code over the years on an ad hoc basis, and presently the various credits are allowable against tax in the chronological order they were added to the Code. This results in several effects which probably were not intended. For example, certain credits for which no carryover is provided may become unusable while a lower-numbered credit for which a carryover is provided is used up. If the order had been reversed, a different result would have occurred.

Differences exist in the manner the various business credits may be used to reduce tax liability. First, credit carryovers are usable in different chronological orders—the investment credits are used on an earliest year first (FIFO) basis, and the other credits are used on a current year first basis. Next, the tax liability limitations for the different business credits differ. The investment tax credit (other than the energy tax credit) may be used to reduce 100 percent of the first $25,000 of tax and 85 percent of the tax in excess of $25,000. The targeted jobs credit may be used against 90 percent of tax liability; the ESOP credit may reduce 100 percent of the first $25,000 of tax liability and 90 percent of the tax in excess of $25,000. The remaining business credits, including the energy tax credit, may reduce 100 percent of tax liability. In each case, tax liability means the income tax imposed reduced by lower numbered credits. Finally, the investment credit, targeted jobs credit, research activities credit, and ESOP credit have a 3-year carryback period whereas the alcohol fuels credit has no carryback period; these credits have a 15-year carryforward period.

Reasons for Change

The committee believes that the present income tax credit mechanism is complex and, at times, not rationally structured. The committee believes that the computations of these credits should be rationalized and simplified. This can be accomplished by allowing the personal income tax credits to be placed first in order, and by combining the business credits into one credit with uniform carryover and tax liability limitations. The committee also believes taxpayers should generally not be able to eliminate their entire tax liability by use of the credits which provide business incentives. However, the committee believes that the research credit is of such importance that it should not be restructured at this time.

The committee recognizes that the foreign tax credit is different in purpose and concept from the personal credits and the incentive credits, and should not be included in such a uniform credit.

Explanation of Provision

Under the bill, the personal income tax credits—the dependent care credit, credit for elderly and disabled, residential energy credit and political contribution credit—will be allowable against tax before all other credits. Next the foreign tax credit, credit for clinical testing of certain drugs, and fuel production credit will be allowable against tax under the conditions of present law.

The business income tax credits—the investment tax credit (both the regular and the energy credits), targeted jobs credit, alcohol fuels credit, and ESOP credit—will be combined into one general business credit. This credit will be allowable against 100 percent of the first $25,000 of tax liability and 85 percent of the remaining tax liability. Tax liability generally means the income tax imposed reduced by other nonrefundable credits. The credit will be used on a FIFO basis with a 3-year carryback and 15-year carryforward period. The research activities credit will continue to be allowed against 100 percent of a taxpayer's tax liability.

Effective Date

The provision will be effective for taxable years beginning after 1983. Credits earned in pre-1984 years will continue to be carried to post-1983 years under the substantive rules (apart from the tax liability limitations) under which they were earned. Likewise, credits earned in post-1983 years may be carried back to pre-1984 years, subject to the new tax liability limitation rules imposed by the bill.

Revenue Effect

The provision will increase revenues by $100 million in fiscal 1984, $183 million in fiscal 1985, $179 million in fiscal 1986, $194 million in fiscal 1987, by $110 million in fiscal 1988 and by $25 million in fiscal 1989.

I. Miscellaneous Tax Provisions

1. Rollover of Certain Partial Distributions From Qualified Plans (sec. 491 of the bill and sec. 402(a) of the Code)

Present Law

Under present law, an employee's benefits from or under a tax-qualified pension, profit-sharing, stock bonus plan, or a qualified annuity plan generally are includible in income when the benefits are distributed. If the balance to the credit of an employee is paid to the employee or to the surviving spouse of the employee as a qualifying rollover distribution, all or any portion of the distribution may be rolled over, within 60 days of the date of the distribution, to another qualified pension, etc., plan or an individual retirement account, annuity, or retirement bond (an IRA). If a rollover is made, tax is deferred on the portion of the distribution rolled over. Under present law, no rollover is permitted for a plan distribution that is not a total distribution.

Present law defines a qualifying rollover distribution as one or more distributions (1) within one taxable year of the employee on account of the termination of the plan or, in the case of a profit-sharing or stock bonus plan, a complete discontinuance of contributions under the plan, (2) that constitute a lump-sum distribution, or (3) that constitute a distribution of accumulated deductible employee contributions.

Similar rules apply under present law to benefits under tax-sheltered annuity contracts. Consequently, a lump-sum distribution under a tax-sheltered annuity contract also may be rolled-over, tax-free, to another tax-sheltered annuity contract or to an IRA. Tax-sheltered annuity contracts may be purchased for employees by certain tax-exempt organizations or by public educational organizations.

A distribution is a lump-sum distribution only if it consists of the balance to the credit of the employee under the qualified pension, etc., plan or tax-sheltered annuity contract, is made within one taxable year of the recipient, and is made on account of the employee's attainment of age 59½, separation from service, or death. In the case of a self-employed individual, a lump-sum distribution may be paid on account of attainment of age 59½, death, or disability.

If an employer maintains more than one qualified pension, etc., plan, present law requires that all qualified pension, etc., plans of the employer of the same type (*e.g.*, all profit-sharing plans) generally must be aggregated for purposes of determining whether the balance to the credit of the employee has been distributed in a lump sum distribution. A special exception applies solely for purposes of the rollover provisions. Consequently, if an employer maintains two qualified pension plans, one of which is a defined benefit pension plan and one of which is a money purchase pension plan, and the balance to the credit of an employee in the money purchase pension plan is distributed, the balance to the credit of the employee under the defined benefit pension plan is not counted under the aggregation rules. In the case of a tax-sheltered annuity contract, the aggregation rules provide that all tax-sheltered annuity contracts purchased for an employee by one employer are treated as a single contract for purposes of determining the balance to the credit of the employee.

Under present law, if no part of a lump sum distribution from a qualified pension, etc., plan is rolled over, it may be accorded special 10-year income averaging.[39] Also, present law provides that if a lump sum distribution includes employer securities with unrealized appreciation, the unrealized appreciation generally is not includible in gross income until the securities are sold or exchanged. This rule applies whether or not all or a portion of the distribution is rolled over to another qualified plan or to an IRA.

Reasons for Change

The committee believes that tax-free rollover of partial distributions from qualified plans or tax-sheltered annuity contracts should be permitted, provided that favorable tax treatment (*i.e.*, 10-year income averaging or long-term capital gains treatment) is denied for subsequent distributions.

Explanation of Provision

Under the bill, distributions of less than the balance to the credit of an employee under a qualified pension, etc., plan, qualified annuity plan, or a tax-sheltered annuity contract may be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution would be permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, determined immediately before the distribution, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment at the time and in the manner prescribed by the Secretary of the Treasury. For purposes of determining whether a distribution is at least 50 percent of the balance to the credit of the employee under a qualified pension, etc., plan or a tax-sheltered annuity contract, amounts credited under similar other qualified plans or tax-sheltered annuity contracts of the same employer are counted.

As under present law, the rollover of a partial distribution must be made within 60 days after the date of the distribution. If the employee or surviving spouse of the employee elects partial distribution rollover treatment, no portion of the distribution may be rolled over to another qualified pension, etc., plan or a tax-sheltered annuity. In addition, no special treatment would be accorded to net unrealized appreciation of employer securities. Any subsequent distribution from the same plan (or any other plan of the employer required to be aggregated for the lump sum distribution rules) would not be eligible for the special 10-year income averaging and long-term capital gain treatment accorded lump sum distributions. Similarly, if an employee elects partial distribution rollover treatment under a tax-sheltered annuity, a subsequent distribution under any other tax-sheltered annuity of the same employer would not be eligible for long-term capital gains treatment.

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[39] Alternatively, a part of the distribution may be accorded long-term capital gain treatment. Long-term capital gain treatment also may be available with respect to a qualifying rollover distribution under a qualified annuity plan or a tax-sheltered annuity contract.

In the case of a rollover of a partial distribution, the maximum amount rolled over may not exceed the portion of the distribution includible in gross income. Also, amounts in IRAs could not be rolled over to a qualified pension, etc., plan or to a tax-sheltered annuity contract if the balance in the IRA consists, in part, of a rollover of a partial distribution.

Effective Date

The provision will be effective for distributions made after the date of enactment, in taxable years ending after that date.

Revenue Effect

This provision will have a negligible effect on revenues.

2. Treatment of Certain Related Party Transactions (sec. 168 of the bill and sec. 267 of the Code)

Present Law

Under present law, an accrual-basis taxpayer is denied a deduction for certain accrued expenses or interest owed to related persons who use the cash method of accounting (sec. 267(a)(2)). The disallowed interest and business expenses are those which are not paid to the related person within the taxable year in which the expenses accrue or within 2½ months thereafter. This provision prevents an accrual-basis taxpayer from claiming a deduction for an accrued expense which the related cash-basis payee is not required to take into income until some subsequent time, if at all.

Because an accrued expense is deductible by a taxpayer under the accrual method of accounting only in the taxable year in which it accrues, a deduction disallowed under section 267(a) is permanently lost. It cannot be deducted at some subsequent time when payment is made.

Present law places a subchapter S corporation on the cash method of accounting for purposes of deducting business expenses and interest owed to a related cash-basis taxpayer, including a shareholder who owns at least two percent of the stock in the corporation. Thus, the corporation's deductions (which in the case of a subchapter S corporation are taken into account on the shareholders' returns) are allowed at the same time the income is recognized by the shareholder. Furthermore, no deductions are lost if payment is made after the 2½-month period expires. Present law does not provide a similar rule for payments between an accrual basis partnership and a cash basis partner, although present law requires that guaranteed payments made to a partner be includible in the partner's taxable year corresponding to the year the partnership deducted the payment (secs. 706(a) and 707(c))(an accrual rule).

Finally, present law provides that no deduction is allowed for losses from sales or exchanges of property between related parties, including controlled partnerships (secs. 267(a)(1) and 707(b)(1)). Any gain recognized on a subsequent disposition of the property by the related party is reduced by the disallowed loss.

Reasons for Change

The committee believes that persons who are related should be required to use the same accounting method with respect to transactions between themselves in order to prevent the allowance of a deduction without the corresponding inclusion in income. The failure to use the same accounting method with respect to one transaction involves unwarranted tax benefits, especially where payments are delayed for a long period of time, and in fact may never be paid.

The committee also believes that the present rules may lead to an unduly harsh result in certain circumstances where payment is delayed more than 2½ months while allowing too much of a tax advantage for payments made within 2½ months after the close of a taxable year. Finally, certain related parties, such as a partnership and its partners, should be made subject to the related party rules in order to prevent tax avoidance by the use of different accounting methods.

Explanation of Provision

Under the bill, an accrual-basis taxpayer will be placed on the cash method of accounting with respect to deductions of business expenses and interest owed to a related cash-basis taxpayer. Thus, the accrual-basis taxpayer will be allowed to deduct business expenses or interest owed to a related cash-basis taxpayer when payment is made (whether or not paid within 2½ months after the close of the taxable year); in other words, the deduction by the payor will be allowed no earlier than when the corresponding income is recognized by the payee. This provision will apply to all deductible expenses (whether or not deductible under section 162, 163 or 212) the timing of which depends upon the taxpayer's method of accounting or upon the making of an election to expense an item. It will not apply, for example, to expenses such as the deductions for cost recovery or depreciation of an asset (other than an asset which is related to the performance (or nonperformance) of services by the payee).

The present-law rules relating to accruals by subchapter S corporations will be extended to accruals by partnerships to partners, as well as to accruals by partners to partnerships and shareholders to subchapter S corporations. Also, the 2-percent *de minimis* exception for shareholders of subchapter S corporations is eliminated. Thus, for example, a partnership will not be allowed to deduct accrued business expenses or interest owed to a cash-basis partner until the amounts are paid and are includible in the income of that partner. This cash basis rule will apply to any payment made to a partner holding (actually or constructively) any capital interest or profits interest in the partnership or to any person related to a partner (within the meaning of secs. 267(b) or 707(b)(1)). This rule would not apply, however, to guaranteed payments (within the meaning of sec. 707(c)) made to a partner because the present law accrual rule is continued. Also, this rule will apply to amounts accrued by an "upper tier" partnership (or a partner in the "upper-tier" partnership) which is a partner in a "lower-tier" partnership to partners of the "lower-tier" partnership or to persons related to these partners. Finally, it will apply to amounts accrued by partners (to other partners) on behalf of a partnership, such as those amounts which the payor partner is obligated to make under the terms of the partnership agreement.

To illustrate the foregoing, assume that a corporation owns a one percent profits interest in partnership X and a 51-percent capital and profits interest in partnership Y. Partnership X uses the accrual method of accounting and partnership Y uses the cash method. Under the bill, unpaid interest owed by X to Y cannot be deducted by X until paid to Y, because Y is related to a partner of X by reason of section 707(b)(1)(A). If, however, the corporation has only a 40-percent interest in Y and, therefore, is not related to Y under section 707(b)(1), then the new rule would not apply.[40]

Finally, the bill extends the loss disallowance and accrual provisions of section 267 (as well as other provisions of the Code applicable to related parties defined under section 267) to transactions between certain controlled corporations. For purposes of these loss disallowance and accrual provisions, corporations will be treated as related persons under the controlled corporation rules of section 1563(a), except that a 50-percent control test will be substituted for the 80-percent test.[41] (These rules are not intended to overrule the consolidated return regulation rules where the controlled corporations file a consolidated return.) DISCs are not to be included in the controlled group for purposes of the loss rules. The section 267 rules also are extended to transactions between a partnership or subchapter S corporation and a regular corporation which are commonly controlled. Finally, related parties under the provisions of section 707(b) are treated as related for all purpose of the Code referring to section 267.

Effective Date

The provision relating to timing of accruals will apply to taxable years beginning after December 31, 1983. However, the provision will not apply to (1) interest on indebtedness incurred on or before September 29, 1983 or incurred pursuant to a contract binding on that date and all times thereafter and (2) other expenses made pursuant to a contract which was binding on September 29, 1983, and at all times thereafter.

The provisions expanding the coverage of the related party rules will apply with respect to transactions after September 29, 1983 (other than with respect to amounts paid or incurred pursuant to a contract binding on September 28, 1983, and at all times thereafter). Losses on transfers to a controlled foreign corporation will not be subject to the new rules until March 1, 1984.

Revenue Effect

It is estimated that this provision will increase revenue by $50 million in fiscal year 1984, $114 million in fiscal year 1985, $185 million in fiscal year 1986, $264 million in fiscal year 1987, by $350 million in fiscal year 1988 and by $433 million in fiscal year 1989.

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[40] See Treas. Reg. sec. 1.267(b)-(1) for present law application of section 267 to partnerships. It is expected that the Treasury Regulations under this provision will provide a rule for cases not specifically covered by the new rules where the same persons are partners in both the payor partnership and payee partnership which will defer deductions accruals (until paid) to the extent of such partners' aggregate interests in the payor partnership.

[41] The component member rules of section 1563(b) have no application.

3. Preferred Stock Eligible for Small Business Corporation Stock Treatment (sec. 492 of the bill and sec. 1244 of the Code)

Present Law

Under present law, gain or loss on the disposition of a capital asset (such as corporate stock held for investment purposes) is generally treated as capital gain or loss. A capital loss sustained by an individual first offsets any capital gain. Any excess capital losses may offset up to $3,000 of ordinary income.

Ordinary loss treatment, rather than capital loss treatment, is provided in certain cases for small business corporation stock (section 1244 stock) which is disposed of at a loss. This special treatment is accorded only to individual shareholders to whom the stock was originally issued, and to individuals who are partners in a partnership at the time the partnership acquired the stock from an issuing small business corporation and who share in a loss sustained by the partnership on the section 1244 stock.

The maximum amount of ordinary loss from the disposition of section 1244 stock that may be claimed in any taxable year is limited to $50,000 ($100,000 in the case of married taxpayers filing a joint return).

For stock to qualify as section 1244 stock, the following requirements must be met: (1) the stock must be common stock; (2) the corporation issuing the stock must be a domestic corporation; (3) the equity capital of the corporation may not exceed $1,000,000; (4) the stock must be issued for money or other property, subject to certain exceptions; and (5) the corporation must be engaged in the active conduct of a trade or business.

Reasons for Change

The committee believes that to encourage new venture capital, an ordinary loss deduction should be available on preferred stock, as well as common stock, of small business corporations.

Explanation of Provision

Under the bill, the ordinary loss provisions of section 1244 would be extended to losses on preferred stock of small business corporations. All restrictions applicable under present law to losses on common stock would apply to losses on preferred stock.

Effective Date

The provision applies to stock issued after the date of enactment.

Revenue Effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

4. Medical Expense Deduction for Certain Lodging (sec. 493 of the bill and sec. 213 of the Code)

Present Law

Individuals who itemize deductions may deduct expenses paid during the taxable year, not reimbursed by insurance or otherwise, for medical care of the taxpayer and the taxpayer's spouse and dependents, to the extent that such expenses exceed five percent of adjusted gross income (sec. 213). The term medical care is defined in the statute to include amounts paid for: (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (2) transportation primarily for and essential to such medical care; and (3) insurance covering medical care. The primary rationale for allowing an itemized deduction for medical expenses is that extraordinary medical costs reflect an economic hardship, beyond the taxpayer's control, which reduces the taxpayer's ability to pay Federal income tax.

Reasons for Change

The committee is aware of instances in which an individual must travel away from home to receive medical care. In many such cases, this is because specialized care for a particular disease is not available at home, or because better care is available elsewhere. The committee is also aware that in some cases, the patient is unable to travel alone and must be accompanied by another person (for example, the parent of a minor child).

In some instances, as in the case of some chemotherapy treatment for cancer patients, the treatment away from home can be given in a hospital or hospital-related facility on an outpatient basis, which generally is less expensive than treatment on an inpatient basis in a hospital. While under present law the expenses of a hospital stay are deductible, expenses of lodging incurred away from home during outpatient medical treatment are not eligible for the deduction. The committee believes that a medical expense deduction for lodging expenses should be allowed in appropriate cases.

The committee is concerned, however, that the new provision may be difficult for the Internal Revenue Service to administer. In particular circumstances, it may be difficult to distinguish between a trip that is primarily a vacation and a trip that is primarily for medical care. The committee believes that placing a per-diem cap on the amount that is deductible for away-from-home lodging will be useful in alleviating this concern.

Explanation of Provision

Under the bill, the definition of medical care set forth in section 213(d) is broadened to include amounts paid for lodging while away from home under circumstances in which such lodging is primarily for and essential to medical care provided by a physician in a licensed hospital (or in a medical care facility which is a hospital-related facility or the equivalent of a licensed hospital). Medical care facilities described in this section include out-patient clinics which provide substantial services similar to those provided by hospitals (e.g., the Mayo Clinic). The deduction is not allowed for amounts paid for lodging that is lavish or extravagant under the circumstances. Further, no deduction is allowed for any amount of lodging expenses if there is any significant element of personal pleasure, recreation, or vacation in the travel away from home.

The committee intends that a person accompanying the individual whose lodging expenses are deductible under the bill (e.g., a parent accompanying a dependent child) may deduct lodging expenses if that person's transportation expenses for the trip are deductible as medical expenses under present law.

The amount of the deduction is subject to a limitation of $50 per night for each eligible person. Thus, if a parent accompanies a dependent child on a trip away from home for medical treatment which satisfies requirements of the bill, the parent could deduct up to a total of $100 per day for lodging expenses.

The bill does not allow a deduction for any expenses, such as food, other than the cost of lodging.

Effective Date

The provision applies to taxable years beginning after December 31, 1983

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $1 million in fiscal year 1984; $7 million in 1985; $10 million in 1986; $10 million in 1987; and $11 million in 1988; and $12 million in 1989.

5. Study of Simplified Tax on Gross Income (sec. 494 of the bill)

The bill provides that the Secretary of Treasury shall submit to the Congress, within 6 months of the enactment of this bill, a report on a study of the advisability of replacing the current income tax system (individual and/or corporate) with a simplified gross income tax. The study should take into account the following factors: (1) protecting the economically disadvantaged; (2) reducing administrative complexity; (3) reducing paperwork, auditing requirements, tax evasion, and expediting the resolution of taxpayer-government disputes; (4) increasing economic incentives for capital formation and productivity; (5) removing economic disincentives to employment; and (6) excluding certain items (such as social security benefits) from gross income.

J. Repeal of Certain Obsolete Provisions (Deadwood)

1. Termination of Rules Relating to Qualified Bond Purchase Plans and Retirement Bonds (sec. 497 of the bill and secs. 405 and 409 of the Code)

Present Law

Qualified bond purchase plans

Under present law, a bond purchase plan maintained by an employer and funded through the purchase of certain Federal bonds is a qualified plan if it meets specified requirements.[42] Under the Code, the bonds must be issued in the names of the individual employees (including self-employed individuals) on whose behalf they are purchased and must be nontransferable. The terms of the bonds provide for payment of interest, or investment yield, only upon redemption and provide for cessation of interest accruals, or investment yield, not later than five years after the death of the individual in whose name the bonds are purchased. Moreover, no amounts are included in an individual's gross income until the bonds are redeemed, which cannot occur until the named individual dies, becomes disabled, or attains age 59½.

The income portions of the proceeds of the redemption of bonds purchased under qualified bond purchase plans may be rolled over, tax-free, to an individual retirement account or annuity (an IRA), if the rollover is made within 60 days after the individual receives the proceeds of the redemption. If no rollover is made, the income portion of the redemption proceeds are includible in gross income. The income is not eligible for the long-term capital gains or 10-year income averaging treatment available for certain lump-sum distributions from tax-qualified pension, profit-sharing, or stock bonus plans. The bond are eligible, however, for certain estate tax and gift tax exclusions provided to tax-qualified plans.[43]

Individual retirement bonds

Under present law, an individual is allowed an annual deduction for contributions to purchase a qualified retirement bond.[44] The deduction is generally limited to the lesser of $2,000 or 100 percent of compensation (earned income in the case of a self-employed individual). A qualified retirement bond is a bond issued under the Second Liberty Bond Act that accumulates interest until the time of redemption. The bonds are issued in the name of the individual

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[42] Sec. 405(a)(1). The plan must meet the requirements of section 401(a) relating to coverage and discrimination (sec. 401(a)(3), (4), (5) and (6)), vesting (sec. 401(a)(7), (8), and (9)), limitations (401(a)(16)), and may be subject to rules relating to distributions and self-employed individuals (sec. 401(a)(9) and (10)).

[43] Treas. Reg. secs. 20.2039-2(b) and 25.2517-1(b).

[44] Sec. 219(a).

(the registered owner) on whose behalf they are purchased and are not transferable.

When the bonds are redeemed, the full proceeds of the bonds, including interest earned, are included in the individual's gross income unless the proceeds are rolled over to an IRA.[45] If a bond is redeemed before the registered owner attains age 59½, has died, or has become disabled, a 10-percent additional income tax is imposed on the redemption proceeds. No deduction is allowed with respect to a bond that is redeemed within 12 months of the date of purchase and the proceeds of such a bond are not includible in gross income.

A qualified retirement bond ceases to bear interest in the year in which the registered owner attains age 70½ and the value of the bond is includible in the registered owner's gross income in that year, whether or not the bond is redeemed. If the registered owner dies before age 70½ or before the bond is redeemed, the bond ceases to bear interest five years after the registered owner's death or the date the registered owner would have attained age 70½, if earlier.

Redemption proceeds from qualified retirement bonds are eligible for tax-free rollovers to individual retirement accounts or annuities. Additionally, the bonds are eligible for certain estate tax and gift tax exclusions.[46]

Termination of sales

In a news release dated April 27, 1982, the Treasury Department announced that sales of bonds for qualified bond purchase plans and of individual retirement bonds would be terminated effective April 30, 1982. The Treasury Department indicated that sales of the bonds in recent months had been negligible. Bonds issued prior to April 30, 1982, continue to be subject to the terms and conditions in effect when they were issued.

Reasons for Change

Because new bonds cannot be purchased, the retirement plans of present bondholders may be disrupted unless the proceeds of the bonds can be reinvested in other retirement arrangements. The committee believes it is appropriate to permit bonds purchased under qualified bond purchase plans to be redeemed before the registered owner attains age 59½. In addition, in order to provide greater investment flexibility to a bondholder (under a qualified bond purchase plan) who also participates in a qualified pension, etc., plan, the committee believes that the rollover of redemption proceeds to a qualified pension, etc., plan should be permitted.

Explanation of Provision

The bill repeals sections 405 and 409 of the Internal Revenue Code, relating to qualified bond purchase plans and individual retirement bonds. Notwithstanding the rules of section 405 (as in effect before repeal) and the terms of any bond issued under a qualified bond purchase plan, the bill permits an individual to redeem a bond at any time even though the individual has not attained age 59½.

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[45] Sec. 409.

[46] Secs. 2039 and 2517(a).

In addition, the bill provides that the redemption proceeds of bonds provided under a qualified bond purchase plan may be rolled over, tax-free, to a qualified pension, etc., plan. If such a rollover is made, however, the rollover amounts (1) must be subject to separate accounting under the recipient plan, and (2) are not eligible for capital gain or 10-year income averaging treatment, or the special treatment of net unrealized appreciation from employer securities.

Effective Date

The provision generally will be effective for obligations issued after December 31, 1983.

The provision relating to rollovers will be effective with respect to redemptions made after the date of enactment.

Revenue Effect

This provision will have no revenue effect.

2. Repeal of Section 1251 (relating to gains from disposition of certain property used in farming (sec. 498 of the bill and sec. 1251 of the Code)

Present Law

Section 1251 was enacted in 1969 to prevent certain high income taxpayers from using farm losses to defer their non-farm income and then later obtaining capital gains on the disposition of their farm property. The Tax Reform Act of 1976 terminated these provisions with respect to farm losses incurred after 1975.

Reasons for Change

The committee believes that section 1251 should be repealed as deadwood since it no longer serves a meaningful function.

Explanation of Provision

The bill repeals section 1251, as deadwood.

Effective Date

The repeal of section 1251 will be effective for taxable years beginning after 1983.

Revenue Effect

This provision will have no revenue effect.

TITLE V—FRINGE BENEFITS PROVISIONS

A. Present Law

General rules

The Internal Revenue Code defines gross income for purposes of the Federal income tax as including "all income from whatever source derived," and specifies that it includes "compensation for services" (sec. 61). Treasury regulations provide that gross income includes compensation for services paid other than in money (Reg. sec. 1.61-1(a)). Further, the U.S. Supreme Court has stated that Code section 61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."[1]

The social security and unemployment insurance payroll taxes (FICA and FUTA, respectively) and income tax withholding apply to "wages," defined in the statutes as all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash (secs. 3121(a), 3306(b) and 3401(a)). The railroad retirement tax (RRTA) applies to any form of money remuneration (sec. 3231(e)). Regulations applicable to these statutes specify that the value of any noncash item is to be determined by the excess of its fair market value over any amount paid by the recipient for the item (see, e.g., Reg. sec. 31.3121(a)-1(e)).

Certain employee benefits, such as health plan benefits, are excluded by statute from gross income and wages. Nontaxable benefits offered under a plan which offers a choice between taxable and nontaxable benefits (a "cafeteria plan") may be excluded from gross income if certain conditions are met (sec. 125).

Moratorium on issuance of regulations

In 1975, the Treasury Department issued a discussion draft of proposed regulations which contained a number of rules for determining whether various nonstatutory fringe benefits constitute taxable compensation.[2] Public Law 95-427, enacted in 1978, prohibited the Treasury Department from issuing, prior to 1980, final regulations under section 61 of the Internal Revenue Code relating to the income tax treatment of fringe benefits. That statute further prohibited Treasury from proposing regulations relating to the treatment of fringe benefits under section 61 which would be effective prior to 1980.

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[1] *Comm'r* v. *Smith*, 324 U.S. 177, 181 (1945). Similarly, the Court has stated: "Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted" (*Comm'r* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955)).

[2] 40 Fed. Reg. 4118 (Sept. 5, 1975). The discussion draft was later withdrawn (41 Fed. Reg. 5634, Dec. 28, 1976).On January 15, 1981, the Treasury Department forwarded to the Committee on Ways and Means a revised discussion draft of proposed regulations on the tax treatment of fringe benefits. This discussion draft was not reviewed by the Secretary of the Treasury and was not published in the Federal Register. The discussion draft was reprinted in various publications, including Bureau of National Affairs, Daily Executive Report (Jan. 16, 1981), at p. J-14.

Public Law 96-167, enacted in 1979, extended the moratorium on issuance of fringe benefit regulations through May 31, 1981. That extension prohibited the Treasury Department from issuing, prior to June 1, 1981, final regulations under section 61 relating to the income tax treatment of fringe benefits. In addition, no regulations relating to the treatment of fringe benefits under section 61 were to be proposed which would be effective prior to June 1, 1981.

The Economic Recovery Tax Act of 1981 (Public Law 97-34) extended the moratorium on issuance of fringe benefit regulations through December 31, 1983. Under the 1981 Act, the Treasury Department is prohibited from issuing, prior to January 1, 1984, final regulations under section 61 relating to the income tax treatment of fringe benefits. In addition, no regulations relating to the treatment of fringe benefits under section 61 are to be proposed which would be effective prior to January 1, 1984.

B. Reasons for Change

In providing statutory rules for exclusion of certain fringe benefits for income and payroll tax purposes, the committee has attempted to strike a balance between two competing objectives.

First, the committee is aware that in many industries, employees may receive, either free or at a discount, goods and services which the employer sells to the general public. In many cases, these practices are long established, and have been treated by employers, employees, and the IRS as not giving rise to taxable income. Although employees may receive an economic benefit from the availability of these free or discounted goods or services, employers often have valid business reasons, other than simply providing compensation, for encouraging employees to avail themselves of the products which they sell to the public. For example, a retail clothing business will want its salespersons to wear, when they deal with customers, the clothing which it seeks to sell to the public. In addition, the fact that the selection of goods and services usually available from a particular employer usually is restricted makes it appropriate to provide a limited exclusion, when such discounts are generally made available to employees, for the income employees realize from obtaining free or reduced-cost goods or services. The committee believes, therefore, that many present practices under which employers may provide to a broad group of employees, either free or at a discount, the products and services which the employer sells or provides to the public do not serve merely to replace cash compensation. These reasons support the committee's decision to codify the ability of employers to continue these practices without imposition of income or payroll taxes.

The second objective of the committee's bill is to set forth clear boundaries for the provision of tax-free benefits. Because of the moratorium on the issuance of fringe benefit regulations, the Treasury Department has been precluded from clarifying the tax treatment of many of the forms of noncash compensation commonly in use. As a result, the administrators of the tax law have not had clear guidelines in this area, and hence taxpayers in identical situations have been treated differently. The inequities, confusion, and administrative difficulties for businesses, employees, and the IRS resulting from this situation have increased substantially in recent years. The committee believes that it is unacceptable to allow these conditions—which have existed since 1978—to continue any longer.

In addition, the committee is concerned that without any well-defined limits on the ability of employers to compensate their employees tax-free by using a medium other than cash, new practices will emerge that could shrink the income tax base significantly, and further shift a disproportionate tax burden to those individuals whose compensation is in the form of cash. A shrinkage of the base of the social security payroll tax could also pose a threat to the viability of the social security system above and beyond the adverse projections which the Congress recently addressed in the Social Security Amendments of 1983. Finally, an unrestrained expansion of noncash compensation would increase inequities among employees in different types of businesses, and among employers as well.

The nondiscrimination rule is an important common thread among the types of fringe benefits which are excluded under the bill from income and employment taxes. Under the bill, most fringe benefits may be made available tax-free to officers, owners, or highly compensated employees only if the benefits are also provided on substantially equal terms to other employees. The committee believes that it would be fundamentally unfair to provide tax-free treatment for economic benefits that are furnished only to highly paid executives. Further, where benefits are limited to the highly paid, it is more likely that the benefit is being provided so that those who control the business can receive compensation in a nontaxable form; in that situation, the reasons stated above for allowing tax-free treatment would not be applicable. Also, if highly paid executives could receive free from taxation economic benefits that are denied to lower-paid employees, while the latter are compensated only in fully taxable cash, the committee is concerned that this situation would exacerbate problems of noncompliance among taxpayers. In this regard, some commentators argue that the current situation—in which the lack of clear rules for the tax treatment of nonstatutory fringe benefits encourages the nonreporting of many types of compensatory benefits—has led to nonreporting of types of cash income which are clearly taxable under present-law rules, such as interest and dividends.

In summary, the committee believes that by providing rules which essentially codify many present practices under which employers provide their own products and services tax-free to a broad group of employees, and by ending the uncertainties arising from a moratorium on the Treasury Department's ability to clarify the tax treatment of these benefits, the bill substantially improves the equity and administration of the tax system.

C. Explanation of Provisions

1. Overview

Under the bill, certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes and from the wage base (and, if applicable, the benefit base) for purposes of income tax withholding, FICA, FUTA, and RRTA.

The excluded fringe benefits are those benefits that qualify under one of the following five categories as defined in the bill: (1) a no-additional-cost service, (2) a qualified employee discount, (3) a working condition fringe, (4) a de minimis fringe, and (5) a qualified tuition reduction. Special rules apply with respect to certain parking or eating facilities provided to employees, on-premises athletic facilities, and demonstration use of an employer-provided car by auto salespersons. Some of the exclusions under the bill apply to benefits provided to the spouse and dependent children of a current employee, to former employees who separated from service because of retirement or disability (and their spouses and dependent children), and to the widow(er) of a deceased employee (and the dependent children of deceased employees).

In the case of a no-additional-cost service, a qualified employee discount, employee parking or eating facilities, or a qualified tuition reduction, the exclusion applies with respect to benefits provided to officers, owners, or highly compensated employees only if the benefit is made available to employees on a basis which does not discriminate in favor of officers, owners, or highly compensated employees.

Any fringe benefit that does not qualify for exclusion under the bill (for example, free or discounted goods or services which are limited to corporate officers) and that is not excluded under another statutory fringe benefit provision of the Code is taxable to the recipient under Code sections 61 and 83, and is includible in wages for employment tax purposes, at the excess of its fair market value over any amount paid by the employee for the benefit.

The provisions of the bill generally take effect on January 1, 1984, except that the tuition reduction exclusion applies with respect to education furnished after June 30, 1984.

2. No-additional-cost Service (Sec. 502 of the bill and new Code sec. 132(b))

General rule

Under this category, the entire value of any no-additional-cost service provided by an employer to an employee for the use of the employee (or of the employee's spouse or dependent children) is excluded for income and employment tax purposes. However, the exclusion applies only if the service is available to employees on a nondiscriminatory basis (see description below of the nondiscrimination rules of the bill). The exclusion applies whether the service is provided directly for no charge or at a reduced price or whether the benefit is provided through a cash rebate of all or part of the amount paid for the service.

To qualify under this exclusion, the employer must incur no substantial additional cost in providing the service to the employee, computed without regard to any amounts paid by the employee for the service. For this purpose, the term cost includes any revenue forgone because the service is furnished to the employee rather than to a nonemployee.[3] In addition, the service provided to the employee must be of the type which the employer offers for sale to nonemployee customers in the ordinary course of the line of business of the employer in which the employee is performing services.

Generally, situations in which employers incur no additional cost in providing services to employees are those in which the employees receive, at no substantial additional cost to the employer, the benefit of excess capacity which otherwise would have remained unused because nonemployee customers would not have purchased it. Thus, employers that furnish airline, railroad, or subway seats or hotel rooms to employees working in those lines of business in such a way that nonemployee customers are not displaced, and telephone companies that provide telephone service to employees within existing capacity, incur no substantial additional cost in the provision of these services to employees, as this term is used in the bill.[4]

Line of business limitation

To be excluded under this category, a service must be the same type of service which is sold to the public in the ordinary course of the line of business of the employer in which the employee works. (Thus, types of services most of the employer's production of which are provided or sold to the employer's employees do not qualify for this exclusion.) For purposes of this limitation, a single employer is treated as consisting of more than one line of business if, after aggregating businesses under common control (see "definition of employer," below), the products or services the employer sells to nonemployee customers fall into more than one industry group.

In providing guidance as to the treatment of an employer as consisting of separate lines of business for this purpose, Treasury regulations may take into account the business segments into which corporations divide themselves for financial reporting purposes. Also, Treasury regulations may refer to the Standard Industrial Classifications used for other governmental purposes.

Under this limitation, for example, an employer which provides airline services and hotel services to the general public is considered to consist of two separate lines of business. As a consequence, the employees of the airline business of the employer may not exclude the value of free hotel rooms provided by the hotel business of the employer, and vice versa. The purpose of the line of business limitation is to avoid, to the extent possible, the competitive imbalances and inequities which would result from giving the employees of a conglomerate or other large employer with several lines of business a greater variety of tax-free benefits than could be given to the employees of a small employer with only one line of business. Thus, small businesses will not be disadvantaged in their ability to compete with large businesses providing the same goods or services, and employees of small business will not be disadvantaged, in comparison to employees of multifaceted businesses, in terms of receiving tax-free economic benefits.

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[3] For the purpose of determining whether any revenue is forgone, it shall be assumed by the Treasury Department that the employee would not have purchased the service unless it were available to the employee at a below-market price.

[4] The employer does incur substantial additional cost (and hence the exclusion is not available) if a substantial amount of time is spent by employees in providing a service for other employees, as contrasted with the no-additional-cost situation in which the services provided to the employee (e.g., the in-flight services provided to an airline employee traveling on a standby basis) are merely incidental to services provided to nonemployee customers.

If an employee provides services that directly benefit more than one line of business of the employer, then the individual is treated as performing services in all such lines of business. Thus, for example, the chief executive officer, payroll department employees, and similar "headquarters" employees may exclude the value of no-additional-cost services provided by either the airline or hotel lines of business of the employer if they provide services which directly benefit both those lines of business.

Reciprocal arrangements

Under the bill, the employees of one employer are allowed the no-additional-cost service exclusion for services provided by an unrelated employer (i.e., another employer not under common control) only if the services provided to the employee are the same type of services as provided to nonemployee customers by both the line of business (of the first employer) in which the employee works and the line of business (of the other employer) in which the services are provided to the employee. In addition, both employers must be parties to a written reciprocal agreement under which the employees of each such line of business may receive the service from the other employer,[5] and neither employer may incur any substantial additional cost (including forgone revenue or payments to the other employer) in providing such service or pursuant to such agreement.

The criteria for determining whether two unrelated employers are providing the same type of service are the same as described above (under "line of business limitation") for determining the composition of the distinct lines of business comprised by a single employer. Thus, for example, the exclusion is available if two unrelated airlines provide free standby flights to each other's airline employees, but is not available to a hotel's employees if they receive free standby flights from an airline line of business (whether the airline is operated by the employees' employer or another employer).

Definition of employee

The bill provides that, with respect to a line of business of an employer, the term employee means (1) an individual who is currently employed by the employer in that line of business; (2) an individual who separated from service with the employer in that line of business by reason of retirement or disability; and (3) a widow or widower of an individual who died while employed by the employer in that line of business or of an individual who had separated from service with the employer in that line of business by reason of retirement or disability. The bill also provides that any use (e.g., of a standby airline flight) by the spouse or a dependent child of the employee (as so defined) is to be treated as use by the employee.[6] These definitions are relevant both for purposes of eligibility for the exclusion under the bill and for purposes of defining nonemployee customers.

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[5] Because businesses under common control are considered to be one employer (see "definition of employer," below), employees of one such commonly controlled business are eligible for the exclusion without need for a written agreement with the other commonly controlled business(es); however, the same-line-of-business test still applies in such cases.

Examples

As an illustration of the no-additional-cost service category of excludable benefits, assume that a corporation which operates an airline as its only line of business provides all of its employees (and their spouses and dependent children) with free travel, on the same terms to all employees, as stand-by passengers on the employer airline if the space taken on the flight has not been sold to the public shortly before departure time. In such a case, the entire fair market value of the free travel is excluded under the no-additional-cost service rule in the bill. This conclusion follows because the service provided by the employer to its employees who work in the employer's airline line of business is the same as that sold to the general public (airline flights), the service is provided at no substantial additional cost to the employer (the seat would have been unsold to nonemployees if the employee had not taken the trip),[7] and the eligibility terms satisfy the nondiscrimination rules of the bill since all employees are eligible for the benefit on the same terms.

This exclusion also applies where employees of the airline line of business of an employer receive free stand-by flights from the airline line of business of another employer through a written reciprocal agreement, if the benefit to the employee would have been excluded under this provision of the bill had it been provided in the same manner by the employee's employer. Thus, for example, the free flights furnished by the other employer must be available to the employees of the first employer on the same nondiscriminatory basis as required for the exclusion when furnished by the first employer, and neither employer may incur any substantial cost (including forgone revenue or any payment from one employer to the other) in providing the service or pursuant to the agreement.

Another example of a no-additional-cost service is the provision of utility services to the employees of the utility where there is excess capacity, such as the provision by a telephone company of free or reduced-cost telephone service to its employees.[8] Because the phone lines, switching capacity, and other overhead already exist, the telephone calls which employees may make without charge or at a reduced price impose no substantial additional cost on the employer. Thus, assuming the telephone service is provided to employees on a nondiscriminatory basis, the requirements of this exclusion category are met, and the value of the service is excluded from gross income and wages.

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[6] For this purpose, dependent child means any child (as defined in Code sec. 151(e)(3)) of the employee who is a dependent of the employee or both of whose parents have died. A child of divorced, etc., parents to whom section 152(e) applies is treated as a dependent of both parents.

[7] Neither the provision of meals and refreshments to a passenger, nor any extra fuel consumption attributable to the weight of an additional passenger, is considered a substantial additional cost.

[8] Local telephone service and long-distance telephone service are to be considered the same line of business.

Under the bill, the exclusion for no-additional-cost service is not available, for example, to employees in the hotel line of business of a corporation for receipt of free stand-by travel on an airline operated by the same corporation, or to employees of a consumer goods manufacturer who travel for personal purposes on a company plane (even if the plane is otherwise making a trip on company business). In each of these cases, even assuming that there were no substantial additional cost to the employer in providing the service on a space-available basis, the service is not the same type generally provided to the general public in the specific line of business of the employer in which the employee-recipient works. Accordingly, the requirements of the no-additional-cost exclusion are not satisfied.

3. Qualified Employee Discount (Sec. 502 of the bill and new Code sec. 132(c))

General rule

Under the bill, certain employee discounts[9] allowed from the selling price of qualified goods or services of the employer are excluded for income and employment tax purposes, but only if the discounts are available to employees on a nondiscriminatory basis (see description below of the nondiscrimination rules of the bill). The exclusion applies whether the qualified employee discount is provided through a reduction in price or through a cash rebate from a third party.

The exclusion is not available for discounts on any personal property (tangible or intangible) of a kind commonly held for investment or for discounts on any real property. Thus, for example, the exclusion does not apply to discounts on any employee purchases of securities, gold coins, residential or commercial real estate, or interests in mineral-producing property (regardless of whether a particular purchase is made for investment purposes). This limitation is provided because the committee does not believe that favorable tax treatment should be provided when noncash compensation is provided in the form of property which the employee could typically sell at close to the same price at which the employer sells the property to its nonemployee customers. Under the discount exclusion of the bill, an employee of a brokerage house may purchase stock and receive an excludable discount on a commission (subject to the 20-percent limitation discussed below for discounts on services). However, any discount allowed on the price of the stock itself is not eligible for the discount exclusion.

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[9] The term "employee discount" is defined in the bill as the amount by which the price at which the good or service is provided to the employee by the employer is less than the price at which such good or service is being offered by the employer to customers who are not employees.

Line of business limitation

To qualify under this exclusion, the goods or services on which the discount is available must be those which are offered for sale by the employer to nonemployee customers in the ordinary course of the employer's line of business in which the employee works. (Thus, types of goods or services most of the employer's production of which are provided or sold to the employer's employees do not qualify for this exclusion.) The rules for treatment of a single employer as consisting of more than one line of business are the same as those described above in connection with the exclusion for a no-additional-cost service. However, the discount exclusion is not available for goods or services provided by another employer, whether or not a reciprocal agreement exists, except where commonly controlled businesses are treated as one employer (see "definition of employer," below).

For example, merchandise held for sale in the retail department store line of business of a firm is eligible for the discount exclusion if purchased at a discount by an employee of the firm who works in that line of business. Similarly, an employee who works for a manufacturer assembling appliances is eligible for the discount exclusion if the employee purchases the assembled appliances from the manufacturer-employer at a discount.

On the other hand, if an employee works for a company that consists of more than one line of business, such as a company consisting of a retail department store business, a hotel business, and an electrical component manufacturing business, an employee is eligible for the discount exclusion only for merchandise or services offered to customers in the ordinary course of business in the particular line of business in which the employee works. This is the case regardless of whether the employer makes discounts available to the employees in the other two lines of business. Thus, in this example, employees of the hotel business or of the electrical component manufacturing business are not eligible for the discount exclusion if these employees purchase merchandise at a discount from the employer's department store. However, employees of units of the employer that provide repair, or financing services with respect to, or that sell by catalog, retail merchandise are considered as providing services in the retail merchandise line of business and hence are eligible for excludable discounts on merchandise items.

A grandfather rule under the bill relaxes the line of business limitation in certain existing situations. If (1) on October 5, 1983, the employees of one member ("the first member") of an affiliated group (as defined in section 1504) were entitled to employee discounts at retail department stores operated by another member ("the second member") of the affiliated group, and (2) in the year for which the income and employment tax determination is being made, most of the sales of the affiliated group are attributable to the operation of retail department stores, then, for purposes of the exclusion for qualified employee discounts, the first member of the affiliated group is to be treated as engaged in the same line of business as the second member (the operator of the department stores). Thus, the employees of the first member may exclude qualified discounts received at the retail department stores operated by the second member. This rule does not operate in the reverse direction, however; that is, the employees of the department stores may not exclude any discounts received on property or services offered by the other member of the affiliated group, whether or not such discounts were allowed on October 5, 1983.

Definition of employee

The bill provides that, with respect to a line of business of an employer, the term employee means (1) an individual who is currently employed by the employer in that line of business; (2) an individual who separated from service with the employer in that line of business by reason of retirement or disability; and (3) a widow or widower of an individual who died while employed by the employer in that line of business or of an individual who had separated from service with the employer in that line of business by reason of retirement or disability. The bill also provides that any use (e.g., of discounted goods) by the spouse or a dependent child of the employee (as so defined) is to be treated as use by the employee.[10] These definitions are relevant both for purposes of eligibility for the exclusion under the bill and for purposes of defining nonemployee customers.

Amount of exclusion

General rule.—Under the bill, an employee discount is excluded only up to a specified limit. In the case of merchandise, the excludable amount of the discount is limited to the selling price of the merchandise, multiplied by the employer's gross profit percentage. The discount exclusion for a service may not exceed 20 percent of the selling price, regardless of the actual gross profit percentage.

Merchandise.—In the case of merchandise, the excludable amount of the discount may not exceed the selling price of the merchandise, multiplied by the employer's gross profit percentage. For this purpose, the employer's gross profit percentage for a period means the excess of the aggregate sales price for the period of merchandise sold by the employer in the relevant line of business over the aggregate cost of such merchandise to the employer, then divided by the aggregate sales price.

For example, if total sales of such merchandise during a year were $1,000,000 and the employer's cost for the merchandise was $600,000, then the gross profit percentage for the year is 40 percent ($1,000,000 minus $600,000 equals 40 percent of $1,000,000). Thus, an employee discount with respect to such merchandise is excluded from income to the extent it does not exceed 40 percent of the selling price of the merchandise to nonemployee customers. If in this case the discount allowed to the employee exceeds 40 percent (for example, 50 percent), the excess discount on a purchase (10 percent in the example) is included in the employee's gross income.[11]

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[10] For this purpose, dependent child means any child (as defined in Code sec. 151(e)(3)) of the employee who is a dependent of the employee or both of whose parents have died. A child of divorced, etc., parents to whom section 152(e) applies is treated as a dependent of both parents.

[11] This result occurs because the amount included in gross income as gross income attributable to a discount sale, under section 61, is the difference between fair market value and the price the employee pays for the merchandise. Since the fair market value of merchandise when

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For the purposes of determining the employer's profit percentage, cost is to be computed by the employer in the same manner as it is for computing the employer's Federal income tax liability, under the inventory rules in Code section 471 and the regulations thereunder. Thus, for example, a retailer is to use the "retail method" of pricing inventories under Treas. Reg. sec. 1.471-8 in computing cost for purposes of the gross profit percentage discount limitation if that is the method used by the employer to value inventories for income tax purposes.

The bill provides that an employer may compute the gross profit percentage on the basis of all merchandise held for sale to customers (including employee customers) in the employer's line of business in which the employee works. As an alternative, the employer may select any reasonable classification of such merchandise for the computation. For example, a retail department store business may compute a gross profit percentage for the store business as a whole, or may compute different gross profit percentages for different departments or types of merchandise (high markup items versus low markup items), provided such classifications are made on a reasonable basis. Under either computation method, the determination of the gross profit percentage is to be made on the basis of the employer's experience during a representative period, such as the prior year.

Services.—The discount exclusion for a service is limited to 20 percent of the selling price of the service; there is no profit percentage limitation. The selling price is the price at which the service is provided in the ordinary course of business to customers who are not employees.[12]

Selling price.—Regulations under section 61 for the valuation of nonexcluded discounts provided to employees are to provide that if, in a line of business, a discounted price is, in effect, the price at which a product or service is offered to the public because a discount is regularly provided by the employer in the ordinary course of business through arrangements negotiated with large groups of consumers (e.g., to all members of professional associations) and substantial sales are made at a discount under these agreements, then the fair market value of the discounted products or services is to be measured by reference to the regularly discounted group selling price. In such a case, the regularly discounted group selling price also is to be used to compute the limit on the exclusion for qualified employee discounts on services, for example, so that an employee includes amounts in income on a purchase of services at a discount only to the extent that the price charged to the employee was less than 80 percent of the discounted group selling price.

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sold to employees is the price at which the merchandise is being offered by the employer to customers who are not employees, the 50-percent discount in the example is included in gross income. Under the bill, a discount of 40 percent is excluded from gross income. The net result is that 10 percent of the selling price is included in the employee's gross income.

[12] For purposes of this provision, an insurance policy is considered a service. Thus, an exclusion is allowed for up to 20 percent of the price of the policy. This exclusion does not apply to loans given by financial institutions to their employees at a discounted rate of interest.

Leased sections of department stores

In cases in which a department store leases floor space to another employer (such as a cosmetics firm), and employees of the lessee engage in over-the-counter sales of merchandise which appear to the public to be made by department store employees, then, for purposes of the exclusion in the bill for qualified employee discounts, the leased section is treated as part of the line of business of the employer operating the department store, and the employees of the lessee who are in the leased section are treated as employees of the department store. Thus, even if such individuals selling cosmetics on the department store floor are actually employees of the cosmetic company rather than of the store, they are considered employees of the department store for purposes of the exclusion for qualified employee discounts. Accordingly, if these individuals in the leased section receive from the store a qualified discount on their purchases of goods in the store other than cosmetics, the amount of the discount (subject to the profit percentage limitation) is excluded from income. (Of course, the exclusion is not available to other employees of the cosmetics firm who do not engage in over-the-counter sales in the leased section of the store.) Likewise, because the cosmetic section itself is considered part of the department store line of business, any qualified discount allowed to department store employees by the cosmetics firm to purchase cosmetics in the leased section is excluded (subject to the profit percentage limitation).

4. Working Condition Fringe (Sec. 502 of the bill and new Code sec. 132(d))

General rules

Under the bill, the fair market value of any property or services provided to an employee of the employer is excluded for income and employment tax purposes to the extent that the costs of the property or services would be deductible as ordinary and necessary business expenses (under Code secs. 162 or 167) if the employee had paid for such property or services. The nondiscrimination rules applicable to certain other provisions of Title V of the bill do not apply as a condition for exclusion as a working condition fringe, except for employee parking (as described below).

Examples

By way of illustration, the value of use by an employee of a company car or airplane for business purposes is excluded as a working condition fringe. (However, use of a company car or plane for personal purposes is not excludable. Merely incidental personal use of a company car, such as a small detour for a personal errand, might qualify for exclusion as a de minimis fringe.) As another example, assume the employer subscribes to business periodicals for an employee (e.g., a brokerage house buys a financial publication for its brokers). In that case, the fair market value of the subscriptions is an excluded working condition fringe, since the expense could have been deducted as a business expense if the employee had directly paid for the subscription.

Examples of other benefits excluded as working condition fringes are those provided by an employer primarily for the safety of its employees, if such safety precautions are considered ordinary and necessary business expenses. For example, if for security reasons the U.S. Government or a private business provides a bodyguard or car and driver to an employee, the value of the bodyguard or use of the car and driver is treated as a working condition fringe and hence is not includible in income of the employee. Other examples of excluded working condition fringes are employer expenditures for on-the-job training or travel by an employee if such expenditures meet the present-law requirements for deductibility under section 162.

In contrast, assume that an employer agrees to pay the real estate broker's commission on the sale of an employee's house to assist the employee in moving to another job site for the employer. The payment of the commission by the employer is not excludable as a working condition fringe, because direct payment of the commission expense by the employee would not be deductible by the employee as a section 162 business expense.[13]

The fair market value of the use of consumer goods which are manufactured for sale to nonemployee customers and which are provided to employees for product testing and evaluation outside the employer's office is excluded as a working condition fringe only if (1) consumer testing and evaluation of the product is an ordinary and necessary business expense of the employer, (2) business reasons necessitate that the testing and evaluation be performed off-premises by employees (i.e., the testing and evaluation cannot be carried out adequately in the employer's office or in laboratory testing facilities), (3) the item is furnished to the employee for purposes of testing and evaluation, (4) the item is made available to the employee for no longer than necessary to test and evaluate its performance, and the item must be returned to the employer at completion of the testing and evaluation period, (5) the employer imposes limitations on the employee's use of the item which significantly reduce the value of any personal benefit to the employee, and (6) the employee must submit detailed reports to the employer on the testing and evaluation. The fifth requirement above is satisfied, for example, if (i) the employer places limitations on the employee's ability to select among different models or varieties of the consumer product which is furnished for testing and evaluation purposes, (ii) the employer's policy provides for the employee, in appropriate cases, to purchase or lease at his or her own expense the same type of item as that being tested (so that personal use by the employee's family will be limited), and (iii) the employer requires that members of the employee's family generally cannot use the item. If products are furnished under a testing and evaluation program only to officers, owners, or highly compensated employees, this fact may be considered in a determination of whether the goods are furnished for testing and evaluation purposes or for compensation purposes, unless the employer can show a business reason for the classification of employees to whom the products are furnished (e.g., that automobiles are furnished for testing and evaluation by an automobile manufacturing company to its design engineers and supervisory mechanics.)

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[13] A portion of this amount might be deductible, however, as a moving expense under Code section 217.

Employee parking

Under a special rule in the bill, the fair market value of free or reduced-cost parking provided to an employee on or near the business premises of the employer is excludable as a working condition fringe. For officers, owners, or highly compensated employees, however, this exclusion applies only if such parking is available on a nondiscriminatory basis (see description below of the nondiscrimination rules of the bill).

Demonstration use by auto salespersons

Under a special rule, the fair market value of any use of an employer-provided automobile by an automobile salesperson in the geographic sales area in which the dealer's sales office is located is an excludable working condition fringe if (1) such use of the car is provided primarily for the purpose of facilitating the salesperson's performance of services for the employer, and (2) there are substantial restrictions on the personal use of the car by the salesperson. For example, if an auto salesperson is required to have a car available for showing to customers during working hours, is required to drive the make of car which the auto dealer sells, is limited in the amount of miles he or she may drive the auto, may not store personal possessions in the auto, and is prohibited from using the car for vacation trips, then use of the car in the sales area qualifies for the exclusion under the bill.

5. De Minimis Fringe (Sec. 502 of the bill and new Code sec. 132(e))

General rules

Under the bill, if the fair market value of any property or a service that otherwise would be a fringe benefit includible in gross income is so small that accounting for the property or service would be unreasonable or administratively impracticable, the value is excluded for income and employment tax purposes. The nondiscrimination rules applicable to certain other provisions of the bill do not apply as a condition for exclusion of property or a service as a de minimis fringe, except for subsidized eating facilities (as described below).

In determining whether the de minimis exclusion applies, the fair market values of all property or services provided to an individual during a calendar year are to be aggregated, *except* for (1) property or services that are excluded from taxation under another specific statutory exclusion provision of the Code, as amended by this bill (such as health benefits or qualified employee discounts) and (2) any nonexcluded property or service provided to the employee that (without regard to the aggregation rule) does not qualify as a de minimis fringe because the value of the individual item is too large.

To illustrate, benefits which generally are excluded from income and employment taxes as de minimis fringes (without regard to the aggregation rule) include the typing of personal letters by a company secretary, occasional personal use of the company copying machine, monthly transit passes provided at a discount not exceeding $15, occasional company cocktail parties or picnics for employees, occasional supper money or taxi fare because of overtime work, traditional holiday gifts of property with a low fair market value, occasional theatre or sporting event tickets, and coffee and doughnuts furnished to employees.

Subsidized eating facilities

If an employer provides and operates an eating facility for its employees on or near the employer's business premises and if revenue derived from the facility normally equals or exceeds the direct operating costs of the facility, the excess of the value of the meals over the fees charged to employees is excluded under the bill if the nondiscrimination rules (see description below) are satisfied. (Free meals provided on an employer's premises to employees for the convenience of the employer are excludable from income to the extent provided by present-law section 119, which is not amended by this bill.) While the benefits provided to a particular employee who eats regularly at such a facility may not qualify as a de minimis fringe absent this rule, the recordkeeping difficulties involved in identifying which employees ate which meals on particular days, as well as the values and costs for each such meal, led the committee to conclude that a general exclusion should be provided for subsidized eating facilities as defined in the bill.

6. Qualified Tuition Reductions (Sec. 503 of the bill and Code sec. 117)

The bill adds a new provision to Code section 117 (relating to scholarship and fellowship grants) to exclude, for income and employment tax purposes, the amount of qualified tuition reductions, including cash grants for tuition, provided to an employee of an educational institution (as defined in Code sec. 170(b)(1)(A)(ii)). This new provision supersedes, as of the effective date of the provision, the existing regulation relating to tuition remission (Reg. sec. 1.117-3(a), last sentence). To qualify for the exclusion, the tuition reductions must be made available to employees on a nondiscriminatory basis (see description below of the nondiscrimination rules of the bill).

The bill provides an exclusion for two categories of tuition reduction. The first category applies only to tuition for education at the elementary, secondary, or undergraduate levels and applies whether the education is at the employer educational institution or at another educational institution. The exclusion for the first category is available only for tuition reductions for the education of (1) an individual who is currently employed by the educational institution; (2) an individual who separated from service with the educational institution by reason of retirement or disability; and (3) a widow or widower of an individual who died while employed by the educational institution or of an individual who had separated from service with the educational institution by reason of retirement or disability. Also, the education may be provided to the spouse or a dependent child of an individual described in the previous sentence.[14]

The second category of tuition reduction for which the bill provides an exclusion is the reduction in tuition provided to an employee of an educational institution for the education of the employee at the graduate level, only at the employer educational institution, if the employee is a teaching or research associate or assistant at that institution. An exclusion is not available with respect to any tuition reduction provided for education at the graduate level of a former employee or the spouse or dependents of a current or former employee.[15]

The qualified tuition reduction provision of the bill applies with respect to education furnished after June 30, 1984. The committee intends that present practice with respect to the tax treatment of tuition reduction provided to employees of educational institutions is to remain unchanged until this provision is effective.

7. Athletic Facilities (Sec. 502 of the bill and new Code sec. 132(h)(5))

In general, the fair market value of any on-premises athletic facility provided and operated by an employer for its employees, where substantially all the use of the facility is by employees of the employer (or their spouses or dependent children[16]), is excluded under the bill for income and employment tax purposes. The athletic facility need not be in the same location as the business premises of the employer, but must be located on premises of the employer and may not be a facility for residential use. Examples of athletic facilities are swimming pools, gyms, tennis courts, and golf courses.

The exclusion for certain employer-provided athletic facilities does not apply to the providing of memberships in a country club or similar facility unless the facility itself is owned and operated by the employer and satisfies the employee-use and other requirements for the exclusion. Thus, where no exclusion is available under this provision, the fair market value of such country club membership is includible in the income of the employee who is provided with membership, and is deductible to the extent permitted by present-law sections 162 and 274.

A nondiscrimination requirement is not provided in the bill as a condition for this exclusion, because present law (Code sec. 274) denies a deduction to the employer for costs attributable to a facility which is primarily for the benefit of officers, owners, or highly compensated employees.

8. Nondiscrimination Rules

To qualify under the bill for the exclusions for no-additional-cost services, qualified employee discounts, employee parking or eating facilities, or qualified tuition reductions, the benefit must be available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer that does not discriminate in favor of officers, owners, or highly compensated employees (the "highly compensated group"). If the availability of the fringe benefit does not satisfy this nondiscrimination test, the exclusion applies only to those employees (if any) who receive the benefit and who are not members of the highly compensated group. For example, if an employer offers a 20-percent discount (which otherwise satisfies the requirements for a qualified employee discount) to rank-and-file employees and a 35-percent discount to the highly compensated group, the entire value of the 35-percent discount (not just the excess over 20 percent) is includible in gross income and wages of the members of the highly compensated group who make purchases at a discount.

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[14] For this purpose, dependent child means any child (as defined in Code sec. 151(e)(3)) of the employee who is a dependent of the employee or both of whose parents have died. A child of divorced, etc., parents to whom section 152(e) applies is treated as a dependent of both parents.

[15] The exclusion for the second category of tuition reduction was not provided in H.R. 4170 as orginally reported.

[16] See note 6, *supra*.

The determination of whether a particular classification is reasonable depends on the facts and circumstances involved. A classification that, on its face, makes benefits available only to officers, owners, or highly compensated employees is per se discriminatory, and no exclusion is available to the highly compensated group members for the value of such benefits. On the other hand, an employer could establish a classification that is based on certain appropriate factors, such as seniority, full-time vs. part-time employment, or job description, provided that the effect of the classification is nondiscriminatory. Under a special rule, availability of a tuition reduction benefit only to those employees of an educational organization who are faculty members is not a discriminatory classification. A determination that a classification is reasonable for purposes of applying the nondiscrimination rules of this bill is not to be taken as an indicatio as to whether or not the classification is reasonable for purposes of applying other nondiscrimination rules in the Code, such as the rules in section 401(a)(4) for qualified plans.

Thus, for example, if an employer makes free or reduced-cost parking available to all its employees according to seniority or on a "first-come, first-served" basis, and if those employees who obtain parking constitute a fair cross-section of all employees, then the fair market value of the parking provided is excluded under the bill. A preferential assignment to highly compensated group members of parking space when made for legitimate business reasons (such as a need to use their cars for sales trips or plant inspections during the work day) does not itself violate the nondiscrimination rule, provided that any remaining parking spaces are available to employees on a nondiscriminatory basis. Further, in a situation where parking space is made available on a nondiscriminatory basis, the assignment of particular locations within the parking facility does not have to be made on a nondiscriminatory basis. On the other hand, if an employer provides free or reduced-cost parking only to highly compensated employees without legitimate business reasons, the fair market value of the parking is not excluded for those highly compensated employees.

Another example of a fringe benefit to which the nondiscrimination requirement applies is the provision by retail stores of discounts to employees and their families. Suppose that a store makes this benefit available only to executives and salespersons, but not to employees in other categories, such as clerical and maintenance. To determine whether such a classification would be discriminatory in this particular case, all employees of the store would be divided into categories according to their level of compensation. If the number of the most highly compensated employees to whom the benefit is available, as a proportion of all employees in that category, were not substantially higher than the corresponding proportions for the remaining categories of employees, then the classification would not be considered to be one that discriminated in favor of the highly compensated.

For purposes of the nondiscrimination rule, the determination of which employees are highly compensated would depend on the facts and circumstances of the case, but could rely on Treasury Department guidelines. Examples of such guidelines could be that employees with compensation above, for example, a specific percentile in the employer's compensation distribution or above, for example, a specific annual rate, or both, are to be treated as highly compensated. Such guidelines could vary by industry and could reflect unique characteristics of particular employers or particular industry categories of employment. The committee intends that, insofar as practicable, the Internal Revenue Service is to issue advance determinations as to whether the nondiscrimination requirements of the bill are met in the case of employers, such as nonprofit organizations, to which similar requirements in other sections of the Code have not frequently been applied.

The nondiscrimination rules do not apply to a working condition fringe (other than parking) or a de minimis fringe (other than subsidized eating facilities). For example, if an employer for valid business reasons makes a bodyguard available only to its executives, the working condition fringe exclusion applies even though the availability of the benefit would not satisfy the nondiscrimination rules of the bill.

9. Other Rules

Definition of employer

For purposes of new Code section 132, all employees of all corporations that are members of a controlled group of corporations (within the meaning of Code sec. 414(b)), all employees of all trades or businesses (whether or not incorporated) under common control (sec. 414(c)), or all employees of an affiliated service group (sec. 414(m)) are treated as employed by a single employer. Consequently, if a chain of retail hardware stores separately incorporates each hardware store as a wholly owned subsidiary of one corporation, the employees of one subsidiary may receive qualified employee discounts from stores operated by the other subsidiaries (since all such hardware stores are in the same line of business). Similarly, the nondiscrimination rules are applied under the bill by aggregating related employers, but without aggregating employees in different lines of business (as defined above in the descriptions of the exclusions for no-additional-cost services and qualified employee discounts).

Under the bill, the aggregation of commonly controlled, etc., employers does not change the other requirements for exclusion. For example, if a controlled group of corporations consists of two corporations whose products are in different industry groups, they are not considered as consisting of a single line of business even though treated as one employer. Thus, for example, a qualified employee discount received from a related employer is excludable only if that employer is engaged in the same line of business as that in which the employee works.

Nonapplicability to certain fringe benefits

A benefit is not excludable under new Code section 132 (except pursuant to the exclusion for de minimis benefits) if another section of the Internal Revenue Code provides rules for the tax treatment of that general type of benefit. For example, the fair market value of day care services provided to an employee is excludable only pursuant to the provisions of Code section 129. If in a particular situation such services do not qualify for exclusion under section 129 (e.g., because the nondiscrimination requirements of that section are not met), no exclusion is available under the bill (other than the de minimis exclusion).

Correspondingly, the provisions of section 132 do not modify any present-law statutory exclusions (except to the extent that the bill modifies the definition of cafeteria plans under sec. 125). For example, Code section 119 excludes from the gross income of an employee the value of meals furnished on the employer's business premises for the convenience of the employer. Under Treasury regulations, meals provided free of charge are treated as furnished for the employer's convenience if the meals are furnished for a substantial noncompensatory business reason of the employer. For example, on-premises meals satisfy this requirement if furnished so that the employee is available for emergency calls during meal periods, if employees are restricted to a short meal period which precludes eating out, or if there are insufficient eating facilities in the vicinity (Treas. Reg. sec. 1.119-1(a)). The bill does not affect the present-law exclusion provisions of section 119.

10. Cafeteria Plans (Sec. 502(b) of the bill and Code sec. 125)

The bill amends the definition of cafeteria plans for purposes of Code section 125 to provide that such plans may offer employees choices only among cash or those fringe benefits (other than scholarships or fellowships, educational assistance, vanpooling, and those benefits excludable under provisions of the bill) that are excludable from gross income under a specific section of the Internal Revenue Code.

For this purpose, group-term life insurance that is includible in income only because the amount of the insurance exceeds $50,000 or because the insurance is on the life of the employee's spouse or children is treated as a nontaxable benefit. With respect to vacation days offered under a cafeteria plan, vacation days which cannot be used or cashed out in a later calendar or plan year also are to be treated as a nontaxable benefit. However, vacation days which may be used or cashed out in a later year are to be treated as deferred compensation which may not be offered under a cafeteria plan.

11. Treasury Regulations (Sec. 502 of the bill and new Code sec. 132(k))

Treasury regulations are to be issued to implement the provisions of this bill. Such regulations must be consistent with the language of the bill and with the legislative history (as reflected, in part, in the committee reports on the bill). Thus, any example of a fringe benefit which the reports state is excluded under the bill from income and wages must be so treated in the regulations.

Any fringe benefit that does not qualify for exclusion under the bill (for example, free or discounted goods or services that are made available by the employer only to corporate officers) or under another specific statutory fringe benefit provision is includible in gross income (under Code sections 61 and 83) for income tax purposes, and subject to income tax withholding, FICA, and FUTA, at the excess of its fair market value over any amount paid by the employee for the benefit. For purposes of assisting both taxpayers and the IRS, the Treasury is to issue regulations setting forth appropriate and helpful rules for the valuation of taxable fringe benefits, and coordinating the applications of sections 61 and 83.

The committee notes that noncash remuneration generally is already subject to FICA, FUTA, and income tax withholding under present law. It is intended that, in the absence of a specific statutory provision to the contrary, the regulations under these provisions are to be revised to make clear that remuneration for employment should not be exempt from these employment taxes merely because the remuneration is paid in the form of property or services rather than cash. Since the statutory term "remuneration" is to be interpreted broadly to include compensation for services which have been performed, noncash benefits (such as allowances for meals when the employee is not away from home overnight) which are not excluded under the provisions of this bill or other statutory provisions are to be subject to these employment taxes. This broad interpretation of remuneration is especially important in the case of FICA, for which withholding is generally the only collection method available. In providing guidance to employers concerning the time at which noncash remuneration is considered to be paid by the employer and thus subject to employment taxes, the regulations are to allow sufficient flexibility to minimize administrative problems which employers may have in complying with the law.

The committee understands that under established practices in certain industries, employers may make available to employees damaged, distressed, or returned goods at a price which equals or exceeds the fair market value of such items but which may be less than the cost to the employer of the items before being damaged, etc. In such situations, no amount is to be includible in the employee's income where the purchase price paid by the employee equals or exceeds the fair market value of the item.

Under existing Code provisions and section 61 regulations, benefits to military personnel such as subsistence, housing, and uniform allowances are excludable from income (see Treas. Reg. sec. 1.61-2(b)). This bill does not make any change in existing excludable military benefits. Thus, for example, the value of discounts at military commissaries is to be considered as provision of subsistence under existing regulations and fully excludable without regard to the bill.

D. Effective Date

The provisions of the bill generally take effect on January 1, 1984, except that the exclusion for qualified tuition reductions (sec. 503 of the bill) applies with respect to education furnished after June 30, 1984.

E. Revenue Effect

It is estimated that the provisions of title V of the bill will have no significant revenue effect. The bill serves to codify many present practices under which employers provide their own products and services tax-free to a broad group of employees.

TITLE VI—TECHNICAL CORRECTIONS PROVISIONS

The Technical Corrections Act of 1984 contains technical, clerical, conforming and clarifying amendments to provisions enacted by the Tax Equity and Fiscal Responsibility Act of 1982, the Subchapter S Revision Act of 1982, the Highway Revenue Act of 1982, the Social Security Amendments of 1983 and other recently enacted tax legislation. All amendments made by the title are meant to carry out the intent of Congress in enacting the original legislation. Therefore, no separate "Reasons for Change" is set forth for each individual amendment.

A. Technical Corrections to the Tax Provisions of the Tax Equity and Fiscal Responsibility Act of 1982

1. Alternative minimum tax (sec. 611(a) of the bill and secs. 55-58 of the Code)

Present Law

TEFRA[1] added several new tax preferences and made certain other modifications to the individual alternative minimum tax. This tax is computed at a 20-percent rate and is payable to the extent it exceeds the taxpayer's regular tax. Regular tax generally means the taxpayer's income tax liability reduced by nonrefundable credits. TEFRA generally allowed individuals to elect to take ACRS deductions and the investment tax credit with respect to intangible drilling costs. Also TEFRA provided that the circulation expense deduction, to the extent it exceeded a deduction based on 10-year amortization, was a tax preference for individuals.

Explanation of Provision

In order that a taxpayer may not avoid recapture of investment tax credit on disposition of investment credit property by reason of being subject to the alternative minimum tax, the bill clarifies that the amount of investment credit recapture is not included in the taxpayer's regular tax for purposes of computing alternative minimum liability. As a result, the recapture tax will be a liability in addition to the taxpayer's alternative minimum tax and regular tax.

Also, the bill provides that the election to take ACRS deductions and the investment credit in lieu of expensing intangible drilling costs would not be available with respect to oil, gas and geothermal wells which are not located in the United States, since the investment credit is generally not allowable for property used outside the United States.

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[1] The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248).

Further, the bill amends the circulation expense tax preference provisions by providing a 3-year amortization period (rather than the 10-year period) for individuals to amortize circulation expenses and to measure the tax preference where the expenses are deducted in full under section 173.

Finally the bill clarifies that items of income and deductions from a limited business interest are taken into account in computing net investment income for purposes of the limitation on "below the line" interest deductions, whether or not the deductions from any limited business interest exceed the income from that interest.

2. Casualty loss deduction (sec. 611(c) of the bill and sec. 165 of the Code)

Present Law

TEFRA provided that the itemized deduction for nonbusiness casualty and theft losses is allowed only to the extent the losses exceed 10 percent of the taxpayer's adjusted gross income. In determining adjusted gross income, the deduction for capital gain (under sec. 1202) is allowed. Where a taxpayer's recognized gains from certain involuntary conversions or other casualty losses are in excess of the recognized losses for those transactions for a taxable year, the taxpayer's capital gains deduction for that year, and therefore his or her adjusted gross income, may depend on the amount of casualty loss which is allowable as a deduction (sec. 1231). Thus, in certain circumstances, the computation of the casualty loss deduction may not be mathematically determinable because of the interrelationship with the adjusted gross income determination.

Explanation of Provision

In order to break this circular computation, the bill provides that adjusted gross income, for purposes of computing the 10-percent floor for the casualty loss deduction, is determined without regard to the application of section 1231 to gain or loss from involuntary conversions arising from casualty or theft.

The bill also clarifies that the adjusted gross income limitation applies to estates and trusts.

3. Corporate minimum tax (sec. 612(a) of the bill and sec. 291 of the Code)

Present Law

TEFRA provided a 15-percent cutback in certain corporate tax preferences. These preferences include section 1250 recapture on real estate, mining exploration and development costs, interest incurred by financial institutions to carry certain tax-exempt obligations, and intangible drilling costs of integrated oil companies.

Explanation of Provision

The bill provides that the additional gain recognized as ordinary income on the disposition of section 1250 property under the cutback provision is treated, for all purposes of the Code (such as sections 170, 341, 453B and 751), in the same manner as other section

1250 gain. Since the investment tax credit is generally not allowed for property used outside the United States, the bill provides that no investment credit is allowed for mineral exploration and development costs with respect to mineral deposits located outside the United States. The bill clarifies that, for purposes of applying the preference cutback with respect to interest of financial institutions used to carry tax-exempt bonds, amounts paid in respect of deposits, investment certificates, or withdrawable or repurchased shares are treated as interest, whether or not designated as interest. Finally, the bill clarifies the language providing for the 36-month amortization of drilling and mining costs which are otherwise disallowed by the section.

4. Investment tax credit basis adjustment (sec. 612(b) of the bill and sec. 48(q) of the Code)

Present Law

TEFRA provided a basis adjustment for property with respect to which the investment tax credit is allowed.

Explanation of Provision

The bill clarifies that the basis of an interest in a partnership or S corporation is adjusted to reflect a partner's or shareholder's share of the required adjustments to the basis of partnership or S corporation property when investment credits are either allowed or recaptured. No double basis reductions are intended.

5. Construction period interest and taxes (sec. 612(c) of the bill and sec. 189 of the Code)

Present Law

TEFRA provided that corporations must capitalize construction period interest and taxes with respect to nonresidential real property.

Explanation of Provision

The bill clarifies that construction period interest and taxes with respect to dwelling units in a cooperative housing corporation (as defined in sec. 216) is exempt from the capitalization requirement, since that property is residential property.

6. Leasing (sec. 612(d) and (g) the bill, sec. 168 of the Code, and secs. 210 and 217(e) of TEFRA)

a. Mass commuting vehicles

Present Law

In general, TEFRA modified the safe-harbor leasing rules for leases entered into or property placed in service after July 1, 1982, and repealed safe-harbor leasing for leases entered into after December 31, 1983. However, the TEFRA modifications and repeal of the safe-harbor leasing rules do not apply to qualified mass commuting vehicles. A qualified mass commuting vehicle must be financed in whole or in part by obligations the interest on which is excludable from income.

TEFRA also included a provision to specifically designate ferries as mass commuting vehicles. The effective date of this provision was generally for obligations issued after the date of enactment of TEFRA.

Explanation of Provision

The bill clarifies that, for purposes of safe-harbor leasing, the provision designating ferries as mass commuting vehicles applies to agreements entered into after the date of enactment of TEFRA, without regard to the date on which obligations were issued.

b. Motor vehicle leases

Present Law

Prior to the enactment of TEFRA, the Internal Revenue Service took the position that the presence of a terminal rental adjustment clause in a motor vehicle lease would cause the transaction to be treated as a conditional sale for tax purposes.[2] However, TEFRA provided that the presence of a terminal rental adjustment clause is not to be taken into account in determining whether an agreement is a lease. The TEFRA provision was intended to prevent the Internal Revenue Service from retroactively denying lease treatment for certain motor vehicle leases. The TEFRA provision does not address the legal effect of a terminal rental adjustment clause, nor does it prevent the issuance of regulations addressing the legal effect of these clauses on a prospective basis.[3] The TEFRA provision applies only to operating leases in which the lessee uses the property for business purposes, and if the lessor acquires the property with cash or recourse indebtedness. The TEFRA provision defines a terminal rental adjustment clause as a provision of an agreement that permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of the property.

Explanation of Provision

The bill makes two clarifying amendments to the TEFRA provision for terminal rental adjustment clauses.

The bill clarifies that the term "terminal rental adjustment clause" also includes a provision of an agreement that requires a lessee who is a dealer in motor vehicles to purchase the property for a predetermined price and then resell the property, where such a provision achieves substantially the same results as a provision that permits an upward or downward adjustment of rentals after the disposition of the property by a lessor.

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[2] Technical Advice Memorandum 8019120 (December 20, 1979)

[3] After the enactment of TEFRA, the Internal Revenue Service issued proposed regulations on a prospective basis, under which the presence of a terminal rental adjustment clause would indicate that a motor vehicle agreement is not a lease.Before the enactment of TEFRA, the Tax Court addressed the legal effect of terminal rental adjustment clauses in motor vehicle leases, holding that these transactions are leases and not conditional sales. However, after the enactment of TEFRA, the Ninth Circuit Court of Appeals reversed the Tax Court and upheld the position of the Internal Revenue Service. *Swift Dodge* v. *Comm'r*, 696 F.2d 651 (9th Cir. 1982), *rev'g*, 76 T.C. 547 (1981).

The bill also provides that the TEFRA provision shall not apply to the lessee of a motor vehicle agreement if the lessee treated itself as the owner of the motor vehicle, with respect to the investment tax credit on a Federal income tax return that was filed before the date of the enactment of TEFRA.

7. Foreign taxation (sec. 612 (e) and (f) of the bill and sec. 907 of the Code)

a. Recapture of foreign oil losses

Present Law

TEFRA eliminated the separate foreign tax credit limitation for foreign oil income. Absent relief, the Code's foreign loss recapture rule would cause immediate recapture of one kind of loss (oil or non-oil) against the other kind of income. A special rule, however, limits recapture to 12.5 percent of the pre-TEFRA loss per year. In some cases, however, taxpayers may prefer recapture more rapid than the ratable 12.5 percent per year recapture of present law. For instance, a taxpayer who anticipates receipt of low-taxed foreign source income in the near future and receipt of high-taxed foreign source income in later years may prefer more rapid recapture. In providing relief for taxpayers who benefit from ratable 12.5 percent recapture, Congress did not intend to penalize other taxpayers.

Explanation of Provision

The bill makes clear that taxpayers can elect recapture of one kind of loss (oil or non-oil) over a period shorter than eight years.

b. Definition of foreign oil related income

Present Law

TEFRA imposed current U.S. tax on the U.S. shareholders of controlled foreign corporations that earn foreign base company oil related income. Foreign base company oil related income for this purpose means certain foreign oil related income as defined in section 907(c)(2).

Explanation of Provision

The bill supplements the definition of foreign base company oil related income by specifying that the term also includes foreign oil related income as defined in section 907(c)(3). The term will include certain dividends, interest, deemed distributions under the Subpart F rules, and partnership income. The term will include these amounts only to the extent they constitute foreign oil related income; the term will not include amounts that constitute foreign oil and gas extraction income.

8. Partial liquidations (sec. 612(h) of the bill and sec. 543 of the Code)

Present Law

TEFRA provided that distributions to corporate shareholders in a partial liquidation are excluded from the definition of personal holding company income notwithstanding that they otherwise constitute dividends under the revised treatment of partial liquidations.

Explanation of Provision

In order to treat all dividends in the same manner, the bill deletes this exclusion so that dividends otherwise constituting personal holding company income will be so treated notwithstanding that they are made in a partial liquidation of the distributing corporation.

9. Distribution of appreciated property in redemption of stock (sec. 612(i) of the bill and sec. 311 of the Code)

Present Law

Generally, distributions of appreciated property in redemption of a corporation's stock result in recognition of gain to the distributing corporation. TEFRA excepts from the recognition requirement distributions in partial liquidations and certain distributions of stock or obligations of a controlled corporation if made with respect to qualified stock. Qualified stock is stock held by a noncorporate shareholder who has held at least a 10-percent interest in the distributing corporation for 5 years prior to the distribution (or such lesser period as the distributing corporation or its predecessor existed). The treatment of distributions made to pass-through entities is not entirely clear under the language of TEFRA.

Explanation of Provision

The bill amends the rules relating to qualified stock to provide that, in determining whether the definition of qualified stock is satisfied, distributions to pass-through entities (S corporations, partnerships, trusts, and estates) will be treated as if made directly to the shareholders, partners, or beneficiaries in proportion to their respective interests in the entity. Thus, for example, a distribution to a partnership will not qualify as a distribution with respect to qualified stock to the extent that interests in the partnership are owned by corporations. Further, distributions will not qualify to the extent of an interest in the partnership held by any person whose interest is less than 10 percent, unless stock attributable to such interest when combined with other stock held actually or constructively by such person satisfies the 10-percent requirement. Further, regardless of how long the partnership held the stock in the distributing corporation, the distribution will not satisfy the holding period requirement to the extent it is attributable to a partner whose interest in the partnership was acquired within 5 years (or within such shorter period as the distributing corporation or its predecessor existed) prior to the distribution. Where, however, the stock was contributed to the partnership by the partner, the combined period of ownership by the partner and the partnership will constitute the holding period applicable to the partner.

10. Treatment of certain stock purchases (sec. 612(j) of the bill and sec. 338 of the Code)

a. Definition of purchase for treating certain stock purchases as asset acquisitions

Present Law

A corporation making a qualified stock purchase may treat the acquisition as if the assets of the acquired corporation were purchased. Prior to TEFRA, this treatment applied only if the acquired corporation was liquidated. Under the TEFRA revision of prior law, if the purchasing corporation elects such treatment, the acquired corporation is treated as a new corporation which purchased the assets as of the beginning of the day after the date the qualified stock purchase was completed. Generally, the election may be made only if 80 percent or more of the stock (other than certain nonvoting preferred stock) of the acquired corporation is purchased within a 12-month period.

Stock owned by the acquired corporation in a third corporation is treated as purchased by the acquiring corporation if, as a result of the purchase of stock of the acquired corporation, the acquiring corporation is treated as constructively owning stock in such third corporation. When a corporation (the first corporation) purchases 80 percent of the qualifying stock of another corporation (the second corporation) which in turn owns 80 percent of the stock of a third corporation, the first corporation has not made a qualified stock purchase of the third corporation because it is treated as having purchased only 64 percent (80 percent of 80 percent) of the qualifying stock of such third corporation. However, if an election is made with respect to the qualified stock purchase of the second corporation, the second corporation will be treated as a new corporation which has purchased 80 percent of the third corporation's stock. It is not clear whether such deemed purchase is a qualified stock purchase which enables the second corporation to make an election with respect to the third corporation.

Explanation of Provision

The bill generally conforms the definition of purchase to the definition of prior law (section 334(b)(2)). Under the bill, a purchasing corporation will not be treated as having purchased stock in a third corporation which it constructively owns as a result of purchasing the stock in another (the second) corporation. Instead, if a qualified stock purchase and election are made with respect to the second corporation, the deemed purchase of the third corporation's stock will (if it satisfies the 80-percent ownership requirement) be treated as a qualified stock purchase permitting an election by the second corporation, or deeming an election to be made under certain consistency of treatment requirements, with respect to the third corporation. The acquisition date applicable to the deemed sale by the second corporation is also the acquisition date applicable to the deemed sale by the third corporation.

Generally, under the bill, an election may be made only by a corporation which has made a direct acquisition by purchase of stock satisfying the 80-percent ownership requirement. For this purpose, stock acquired (including stock acquired in a carryover basis transaction after a qualified stock purchase and election with respect to the transferor) from a related corporation, in a transaction which otherwise satisfies the "purchase" requirement, will be treated as purchased if at least 50 percent in value of the stock of the related corporation was acquired by purchase. A corporation is related if stock owned by it is owned by the acquiring corporation. The 12-month acquisition period within which a qualified stock purchase must be made commences, under the bill, not later than the date on which an acquiring corporation first constructively owns stock (other than through ownership of an option) acquired from a related corporation.

A taxpayer making an acquisition before October 21, 1983 may elect to have the new definition of "purchase" not apply.

b. *Limitation on nonrecognition of gain or loss in certain stock purchases treated as asset acquisitions*

Present Law

When an election results in treating an acquired corporation as having sold its assets, gain or loss is not recognized on such constructive sale to the same extent as gain or loss would not be recognized under the rules applicable to an actual sale of assets by, and liquidation of, the acquired corporation (under sec. 337). However, where less than all the stock of such corporation is owned by the acquiring corporation, the portion of the gain or loss not recognized is limited to the highest percentage by value of the acquired corporation's stock owned by the acquiring corporation during the one-year period commencing with the date the qualified stock purchase is completed (the acquisition date). Nonrecognition treatment is not so limited if the acquired corporation is liquidated during such one-year period. Nonrecognition is limited in lieu of imposing a shareholder tax on minority shareholders not disposing of their stock.

Explanation of Provision

Under the bill, the highest percentage of stock held by the acquiring corporation, for purposes of limiting nonrecognition of gain or loss, will be determined by counting increases in its stock ownership after the acquisition date only to the extent such increases are attributable to purchases, or to redemptions of the stock of the target corporation to which either (i) section 302(a) applies, or (ii) in the case of a shareholder who is not a corporation, to which sec. 301 applies. Further, under the bill, the exception to nonrecognition treatment for liquidations during the one-year period is not available if the liquidation is one to which sec. 333 applies. These restrictions are intended to limit nonrecognition of gain or loss to the acquired corporation resulting from transactions after the acquisition date to cases in which stock held by minority shareholders was disposed of in taxable transactions.

c. Purchases by more than one member of an affiliated group in connection with certain stock purchases treated as asset acquisitions

Present Law

If there is both a direct purchase of assets and a qualified stock purchase from the same affiliated group, except as otherwise provided there is a deemed election to treat the stock purchase as a sale and purchase of assets by the acquired corporation. Similarly, if two or more qualified stock purchases are made from the same affiliated group, an election of, or failure to elect, asset sale treatment must be consistently applied to all the acquisitions. In applying these rules, an acquisition of assets or stock by a member of the same affiliated group as the purchasing corporation is treated as made by the purchasing corporation.

Explanation of Provision

The bill clarifies that the aggregation of acquisitions of assets or stock by members of the purchasing corporation's affiliated group is intended to apply only for purposes of the provisions requiring consistency of treatment where assets and stock are purchased, or multiple stock purchases are made, from the same affiliated group. In applying the consistency rules, it is not necessary that the 80-percent purchase requirement be satisfied by one member. However, outside the consistency rules, no qualified stock purchase takes place where several members of an affiliated group that does not file a consolidated return, in the aggregate purchase the required 80 percent of an acquired corporation's outstanding stock but no one member separately satisfies the 80-percent purchase requirement.

A taxpayer may elect to have this provision not apply to acquisitions made before October 21, 1983.

d. Nonrecognition treatment on the sale or exchange of property in connection with certain stock purchases treated as asset acquisitions

Present Law

Gain or loss is not recognized by a corporation on the sale or exchange of property after the adoption of a plan of complete liquidation pursuant to which its assets are all distributed within 12 months (sec. 337). Under TEFRA, these nonrecognition rules apply to the constructive sale and purchase of an acquired corporation's assets resulting from a qualified stock purchase and election. It is not clear, under present law, whether nonrecognition treatment applies to the asset sales when there is a qualified stock purchase and election with respect to an acquired corporation which has sold some of its property following adoption of a plan of liquidation.

Explanation of Provision

Under the bill, if within 12 months preceding the acquisition date of a qualified stock purchase with respect to which an election is made, the acquired corporation adopted a plan of complete liquidation which was not rescinded as of such date, the nonrecognition rules of section 337 will apply to actual sales by the acquired corporation as though it had actually distributed all its assets in liquidation on the acquisition date. The same percentage of gain or loss would be recognized to the acquired corporation with respect to these sales as would be recognized on the deemed sale of its remaining assets resulting from the election. The sale of stock and the deemed distribution will have the same effect as an actual sale of its assets by the acquired corporation to the acquiring corporation followed by a distribution in complete liquidation in applying the provisions providing exclusion from collapsible corporation treatment with respect to sales and exchanges and distributions by the acquired corporation (secs. 341(e)(1), (e)(2) and (e)(4)) and the use of the installment method by shareholders of the acquired corporation (sec. 453(h)).

e. Application of collapsible corporation treatment after stock purchase treated as asset purchase

Present Law

Shareholders in a corporation formed or availed of to enable its shareholders to obtain capital gain treatment attributable to property produced by certain corporate activities before a substantial portion of the taxable income from such property is realized by the corporation, by selling or otherwise disposing of their stock, may instead receive ordinary income from such dispositions under the collapsible corporation rules (sec. 341). When a qualified stock purchase of a collapsible corporation takes place, an election may be made to treat the acquisition as a purchase of assets. However, stock may continue to be owned by minority shareholders after the acquisition date of a qualified stock purchase. Collapsible corporation treatment does not apply to a stock disposition if the corporation has realized the taxable gain from the property. However, the asset purchase election may eliminate such gain, including that attributable to minority owned shares that are purchased by the acquiring corporation, or acquired in certain redemptions, within the 1-year period following the acquisition date.

Explanation of Provision

The bill provides that the election to treat a qualified stock purchase of a collapsible corporation as an asset purchase will be disregarded for purposes of determining whether the collapsible corporation rules apply to a disposition of stock by a minority shareholder within the one-year period following the acquisition date.

f. Fair market value as deemed sale price in certain stock purchases treated as asset acquisitions

Present Law

Under TEFRA, the price at which an acquired corporation's assets are treated as sold and purchased when an election is made with respect to a qualified stock purchase is the basis of the purchasing corporation's stock in the acquired corporation on the acquisition date, properly adjusted for liabilities and other items. For this purpose, the purchasing corporation's basis, if it owns less than 100 percent of the acquired corporation's stock, is "grossed up" to reflect 100-percent ownership. The price paid for the stock of the acquired corporation may be less than the fair market value of its assets to take account, for example, of tax liability resulting from the application of recapture provisions to the deemed purchase and sale of assets. Further, a qualified stock purchase and election may be made notwithstanding that a substantial portion of the value of an acquired corporation is attributable to a class of preferred stock not acquired as part of the qualified stock purchase. The recapture provisions and certain other taxable consequences were applied with reference to the fair market value of an acquired corporation's assets under the provisions applicable prior to TEFRA when a purchase and liquidation of a subsidiary corporation was treated as a purchase of its assets. It is not clear in all cases that a comparable result can be obtained under the adjusted stock basis formula prescribed under TEFRA for determining the deemed purchase price of the acquired corporation's assets.

Explanation of Provision

Under the bill, in order to provide recapture and other taxable treatment comparable to that applicable when a purchased subsidiary was liquidated under prior law, the deemed sale price of the acquired corporation's assets will generally be the fair market value as of the acquisition date. The basis of the assets is adjusted to eliminate unrealized appreciation in the stock of the acquired corporation held by the acquiring corporation on the acquisition date. Thus the adjustment will properly correlate the basis of assets with the cost incurred to acquire the target corporation's stock. If, for example, the acquiring corporation owns all of the target corporation's stock outstanding on the acquisition date, the fair market value of the assets will be adjusted so that their basis, net of liabilities reflected in such basis, will equal the basis in the target corporation's stock on the acquisition date. However, if on such date, the acquiring corporation owns less than all of the target corporation's outstanding stock, the adjustment will result in a net asset basis equal to the basis of the acquiring corporation in the target corporation's stock owned by it on such date plus a percentage of unadjusted net asset fair market value equal to the percentage of the value of the target corporation's stock not owned by the acquiring corporation on such date. The fair market value as adjusted is allocated among the assets under regulations. It is intended that, to the extent of the amount taken into account in determining tax attributable to recapture income from the deemed sale of the target corporation's assets, basis will be assigned to such assets before the remaining basis, if any, is allocated among other assets.

The fair market value and the adjusted fair market value of the assets are to be properly adjusted under regulations, in determining the price at which the assets are deemed sold and purchased, for contingent payments and other relevant items. The consideration to be paid by the acquiring corporation may depend, for example, on the amount of the acquired corporation's liabilities which are not fixed on the acquisition date or on the post-acquisition date earnings of the acquired corporation. In some cases, the aggregate bases in the stock of the acquired corporation held by the acquiring corporation on the acquisition date may exceed the fair market value of the assets on such date. Proper adjustment to the basis of assets may be made to reflect such excess.

g. Period for making election in connection with certain stock purchases treated as asset acquisitions; estimated tax penalty inapplicable

Present Law

An election following a qualified stock purchase must be made, except as regulations provide otherwise, within 75 days after the acquisition date. Section 6655 imposes an addition to the tax for failure of a corporation to timely pay its estimated tax liability.

Explanation of Provision

Under the bill, the election may be made not later than the fifteenth day of the ninth month following the month in which the acquisition date occurs, except as regulations provide otherwise. Tax attributable to the deemed sale resulting from the election will not be taken into account for purposes of the addition to tax under section 6655. Further, it is intended, if the target corporation fails to file the return or pay the tax resulting from the election by the date prescribed for such a filing or payment, that generally the failure will be deemed to be due to reasonable cause and not due to willful neglect in determining the applicability of any addition to tax as a result of such failure, providing a return is filed and the tax is paid by the date for making the election.

The bill allows until 60 days after the date of enactment to make an election with respect to acquisitions of certain banks made during February, 1981.

h. Treatment of certain liquidations for tax avoidance purposes

Present Law

Generally on a complete liquidation of a controlled subsidiary, the acquiring corporation succeeds to its tax attributes, including carryover items. Prior to TEFRA, when an acquired subsidiary corporation was liquidated pursuant to a plan of liquidation adopted within two years following a qualifying purchase of the subsidiary's stock, the transaction was treated as a purchase of the subsidiary's assets and its net operating loss and other carryforward items and other tax attributes were terminated.

Under the TEFRA revision of prior law, the treatment of a qualified stock purchase as an asset acquisition applies on the acquisition date without liquidating the acquired corporation if an election to so treat the purchase is made by the purchasing corporation. If no election is made, the acquired corporation may be immediately liquidated following its acquisition and the acquiring corporation will succeed to its tax attributes (subject to otherwise applicable limitations). When control of a corporation is acquired, or a corporation acquires from another corporation not controlled by the acquiring corporation or its shareholders property with a carryover basis, carryovers and other tax benefits may be disallowed if the principal purpose of the acquisition is tax avoidance or evasion. The application of this disallowance provision in not clear when a purchased corporation with unexpired carryforward items is liquidated into the acquiring corporation.

Explanation of Provision

The bill provides an explicit rule to authorize the disallowance of carryover and other tax benefits of a subsidiary corporation, acquired in a qualified stock purchase with respect to which an election of asset acquisition treatment is not made, if the subsidiary corporation is liquidated pursuant to a plan adopted within two years of the acquisition date and the principal purpose of the liquidation is tax avoidance or evasion. Further, as in Treasury regulation section 1.269-3(b)(1), it is expected regulations will provide that, in the absence of evidence to the contrary, this situation is ordinarily indicative that the principal purpose of the liquidation is tax avoidance.

This provision will apply to liquidations made on or after October 21, 1983. No inference is intended as to the application of section 269 under present law.

i. Regulatory authority to coordinate the rules relating to foreign corporations and shareholders with the rules applicable to an asset acquisition election

Present Law

Present law contains rules providing special treatment of United States shareholders in foreign corporations. Shareholder treatment applicable when an asset acquisition election is made with respect to a qualified stock purchase of a foreign corporation is not consistent with such rules in all cases.

Explanation of Provision

The bill provides for the issuance of such regulations as may be appropriate or necessary to provide for coordination of the rules applicable to an asset acquisition election with respect to a qualified stock purchase of a foreign corporation with the rules relating to foreign corporations and their shareholders.

11. Treatment of certain holding companies (sec. 612(l) of the bill and secs. 304 and 306 of the Code)

a. Amount constituting a dividend in certain redemptions through related corporations

Present Law

If one or more shareholders with 50 percent or greater stock ownership in one corporation transfer stock of that corporation to another corporation in which they have 50 percent or greater stock ownership in exchange for property, the transaction is treated as a dividend to the shareholders if it would be so treated by applying the redemption provisions (sec. 302) with reference to the ownership of the corporation whose stock is surrendered in the transaction. Under the TEFRA revision of these provisions, the determination of the amount which is a dividend is made as if the property were distributed from the issuing corporation to the acquiring corporation and then from the acquiring corporation to the shareholder.

This rule was intended to provide dividend treatment for property received by shareholders to the extent of the aggregate earnings and profits of both the acquiring corporation and the corporation whose stock is acquired in the transaction. However, its application is unclear because, for example, the amount treated as distributed to corporate shareholders is limited with reference to the distributing corporation's basis in the distributed property but is not so limited for shareholders who are not corporations.

Explanation of Provision

In order to clarify the application of the rule adopted by TEFRA, the bill provides that the amount which is a dividend shall be determined as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the corporation whose stock is acquired (the issuing corporation). The transaction would have no effect on the issuing corporation if earnings and profits of the acquiring corporation equal or exceed the amount treated as a distribution in the hands of the shareholders. If the distribution is in excess of the acquiring corporation's earnings and profits, the amount treated as distributed by the issuing corporation will not exceed the earnings and profits of such corporation.

This provision will apply to transactions after October 21, 1983.

b. Coordination of redemptions through related corporations with provisions for nonrecognition of gain or loss

Present Law

Under present law, the exchange of stock in a 50-percent controlled corporation for property from another 50-percent controlled corporation is treated as a stock redemption subject to dividend treatment (under sec. 304). TEFRA provided that the provisions relating to transfers to 80-percent controlled corporations would generally not apply to the extent of the nonstock consideration distributed. However, the language also applies to exchanges governed by the corporate reorganization provisions. Further, redemption treatment was made inapplicable where the property received consists of indebtedness assumed by the acquiring corporation or indebtedness to which the transferred stock is subject if such indebtedness (acquisition indebtedness) was incurred by the shareholder to acquire the transferred stock. Redemption treatment was made inapplicable even if the acquisition indebtedness was assumed in a transaction to which the nonrecognition rules would not apply (one in which the transferors own less than 80 percent of the acquiring corporation). Finally, under TEFRA, stock redemption treatment does not apply to certain minority shareholders who receive securities in an exchange in which stock in a bank is transferred to a newly formed bank holding company provided those who receive property in the exchange do not have control of the bank holding company.

Explanation of Provision

The bill clarifies that only the nonrecognition provision governing transfers to a corporation in which the shareholders have 80 percent control (sec. 351) would be made inapplicable to exchanges involving controlled corporations treated as redemptions. Thus, where the reorganization provisions apply, including those governing the treatment of exchanges by shareholders pursuant to a plan of reorganization, the rules of section 304(a) providing treatment as a stock redemption would not apply.

In order to prevent the "bail out" of earnings by purchasing stock from a related party with borrowed funds and later transferring the stock to a related corporation with the acquisition debt assumed, the bill restricts the exclusion from the rules providing stock redemption treatment for acquisition indebtedness to cases in which the indebtedness is incurred to purchase stock from a person whose stock ownership is not attributable, under section 318(a) (other than paragraph (4)), to the person transferring the stock to the acquiring corporation. An exception applies where the related person terminates its interest in the issuing and acquiring corporations, does not acquire (other than by reason of death) an additional interest in either corporation for ten years, and files an agreement with the Secretary similar to the agreement now required under the regulations under section 302(c)(2). Unitil additional regulations are promulgated for purposes of this new provision, agreements complying generally with the present requirements will suffice. Also, the bill provides that where the shareholders receive property consisting of the assumption of acquisition indebtedness in a corporation in which their control is between 50 and 80 percent, the transaction would be subject to redemption and possible dividend treatment under section 304(a). The amendments to the acquisition debt rule will not apply to stock acquired before October 21, 1983.

The bill clarifies that the assumption by a bank holding company of acquisition indebtedness will not be treated as property received by shareholders in control of the bank holding company for purposes of applying the rule excluding securities received by minority shareholders from the stock redemption rules. Thus the minority shareholders would not be subject to dividend treatment on the receipt of the securities.

c. Modification of constructive ownership rules in applying rules governing redemptions through use of related corporations

Present Law

Under the constructive ownership rules, generally a shareholder is treated as owning stock held by a corporation only if the shareholder directly or indirectly owns 50 percent or more in value of the stock of such corporation and only in proportion to his ownership in the corporation. Conversely, a corporation is generally treated as owning all the stock that is held by persons who are 50 percent or greater shareholders in the corporation. In applying the rules requiring redemption treatment for exchanges of stock for property involving commonly controlled corporations, these 50-percent threshold limitations on attribution of ownership do not apply. As a result, the stock redemption rules may apply when, for example, a corporation sells stock of a subsidiary to a subsidiary of another corporation if a person owns any stock in both the parent of the purchasing corporation and the selling corporation, even though such stock in each case is merely a portfolio investment. A consequence of treating the transaction under the stock redemption rules is that, under those rules, the transferred stock is treated as a contribution to the capital of the acquiring corporation. Concern has been expressed that this treatment precludes treatment of the stock acquisition as a purchase, thus disqualifying it as a qualified stock purchase for purposes of permitting elective asset acquisition treatment by the acquiring corporation (under section 338).

Explanation of Provision

The bill provides a *de minimis* rule that constructive ownership would not apply to and from a corporation and a shareholder owning less than 5 percent in value of the stock of the corporation, for purposes of determining whether or not control exists under section 304. Further, under the bill, where the stock owned by or for a shareholder is less than 50 percent in value of the corporation's stock, attribution of ownership from the shareholder to the corporation is limited to the proportion of the value of the corporation's outstanding stock owned by the shareholder. The bill conforms the analagous constructive ownership rule applicable to the receipt of preferred stock in certain transfers of stock to controlled corporations.

d. Disposition of certain preferred stock

Present Law

If, in lieu of the receipt of cash or other property, shareholders who transfer stock in a controlled corporation to another controlled corporation receive in exchange preferred stock in a transaction in which gain or loss is not recognized, subsequent disposition of the preferred stock may result in ordinary income to the shareholders, if receipt of cash in lieu of stock would have been treated as a dividend. The determination of the character of the hypothetical receipt of cash is made under the rules providing for stock redemption and possible dividend treatment when stock is sold to a commonly controlled corporation. This extension of the treatment generally applicable to preferred stock dividends to preferred stock received in an exchange with a controlled corporation to which the nonrecognition rules apply was adopted by TEFRA. However, the preferred stock affected by this rule may be disposed of in a stock redemption; whether ordinary income results from such redemption is determined by treating it solely as a distribution by the acquiring corporation. The acquiring corporation may be a corporation newly formed or may have little or no earnings and profits so that the distribution would not constitute a dividend.

Explanation of Provision

The bill provides that the dividend equivalence test applied with respect to a hypothetical distribution of cash will be applicable at the time of redemption or other disposition of the preferred stock (or stock whose basis is determined by reference to the basis of the preferred stock) as well as at the time of its receipt. Under this test, treatment of the redemption of the preferred stock as a dividend to the shareholders will be determined with reference to the earnings and profits of the corporation the stock of which was acquired as well as the acquiring corporation.

12. Completed contract method of accounting (sec. 612(l) of the bill and sec. 229 of TEFRA)

Present Law

TEFRA directed the Treasury Department to modify the income tax regulations relating to accounting for long-term contracts. Subsequently, on March 14, 1983, the Treasury Department issued proposed regulations in the Federal Register with respect to accounting for long-term contracts. Those regulations proposed waiving the estimated tax payment penalties for underpayments caused by certain provisions of regulations.[4]

Explanation of Provision

The bill would clarify that the Treasury Department has the authority to waive the penalties as proposed in the regulations.

13. Targeted Jobs Credit (sec. 612(m) of the bill and section 51 of the Code)

Present Law

TEFRA added qualified summer youth employees as an additional targeted group the employers of whom are eligible for the targeted jobs credit.

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[4] Prop. Treas. Reg. sec. 1.451-3(g)(5).

Present law is unclear as to whether a qualified summer youth or a cooperative education youth who continues to work for the same employer after the summer or the education program ends is required to submit to a second determination of economically disadvantaged status in order to be certified as a member of another targeted group for which such status is a requirement.

Explanation of Provision

The bill provides that the original determination that a qualified summer youth or cooperative education youth is economically disadvantaged continues to be valid with respect to the eligibility of the individual as a member of another targeted group, if the individual continues to work for the same employer.

14. Limitations on benefits and contributions under qualified plans (sec. 613(a) of the bill and sec. 415 of the Code)

Present Law

The Code provides overall limits on contributions and benefits under qualified plans, tax-sheltered annuities, and simplified employee pensions for employees of private and public employers. Under a defined benefit plan, before TEFRA, the inflation-adjusted 1982 limit on the annual benefit for an employee was generally the lesser of $136,425 or 100 percent of the employee's average compensation (consecutive high three years). Under a defined contribution plan, before TEFRA, the inflation-adjusted 1982 limit on the annual addition for an employee was generally the lesser of $45,475 or 25 percent of the employee's compensation for the year. If an employee participated in both a defined benefit and a defined contribution plan of an employer, the fraction of each separate limit used was computed and the sum of the fractions was limited to 1.4.

TEFRA generally reduced the overall limits on contributions and benefits under qualified pension, etc., plans, tax-sheltered annuity programs, and simplified employee pensions (SEPs) of private and public employers.

The dollar limit on the annual addition under defined contribution plans was decreased under TEFRA from $45,475 to $30,000, and the dollar limit on the annual benefit payable under defined benefit plans was decreased from $136,425 to $90,000. Beginning in 1986, these amounts will be adjusted for inflation. In addition, for participants covered by both a defined contribution plan and a defined benefit plan of the same employer, the limit on the sum of the fractions of the separate limits used by each plan was reduced to the lesser of 1.25 (as applied only to the dollar limits) or 1.4 (as applied to the percentage-of-compensation limits).

Under TEFRA, if retirement benefits provided by a qualified defined benefit pension plan begin before age 62, the benefit generally is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 62. Similarly, if retirement benefits under a defined benefit plan begin after age 65, the benefit may be increased so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 65.

The TEFRA provision reducing the limits on contributions and benefits is generally effective for years ending after July 1, 1982. For plans in existence on July 1, 1982, however, the provision is effective for years beginning after December 31, 1982. A special effective date was provided for plans maintained on the date of enactment (September 3, 1982) pursuant to one or more collective bargaining agreements between employee representatives and one or more employers.

Special transition rules were provided in connection with the reduced limits. Under TEFRA, a participant's current accrued benefit under a defined benefit pension plan is not reduced merely because TEFRA reduced the dollar limits on benefits payable under the plan. An individual's current accrued benefit is the benefit accrued as of the close of the last year beginning before January 1, 1983. No changes in the terms and conditions of the plan after July 1, 1982, may be taken into account in determining the current accrued benefit under the special transition rules.

TEFRA also provided a special, elective transitional rule for computing the defined contribution fraction in situations in which the employer maintains both a defined contribution plan and a defined benefit plan.

Explanation of Provision

The bill clarifies that the actuarial adjustments required by TEFRA for benefits paid prior to age 62 or after age 65 are applied to the dollar limit on annual benefits ($90,000) rather than to the benefit.

In the case of participants in collectively bargained plans in existence on the date of enactment, the bill provides that the current accrued benefit is the individual's accrued benefit as of the close of the last year beginning before the earlier of (1) the date on which the last of the collective bargaining agreements terminates or (2) January 1, 1986. In addition, the bill provides that, in the case of a collectively bargained plan, changes in the terms and conditions of the plan made pursuant to a collective bargaining agreement reached prior to July 1, 1982, and ratified prior to September 3, 1982, may be taken into account for purposes of computing the current accrued benefit.

The bill clarifies that the special, elective transition rule for computing the defined contribution plan fraction is available only for plans that were in existence on or before July 1, 1982.

15. Loans to plan participants (sec. 613(b) of the bill and sec. 72 of the Code)

Present Law

TEFRA provided that any amount received (directly or indirectly) by a participant as a loan from (1) a qualified pension, etc., plan, (2) a governmental plan (whether or not a qualified plan), or (3) a tax-sheltered annuity contract is treated as a distribution to the participant unless certain requirements are met. For example, a loan that, by its terms, must be repaid within five years generally is not treated as a distribution if the amount of the loan, when added to the outstanding loan balance (principal plus interest) with respect to the employee under all plans of the employer, does not exceed the lesser of (1) $50,000, or (2) 50 percent of the present value of the employee's nonforfeitable accrued benefit under such plan (but not less than $10,000).

TEFRA did not repeal a provision of prior law under which the repayment of a loan from an H.R. 10 plan (a qualified plan covering a self-employed individual) by an owner-employee (a sole proprietor or an individual partner who owns more than 10 percent of a partnership) was treated as a contribution to the plan. Amounts treated as contributions under the rule were subject to the limit on deductions for contributions to H.R. 10 plans.

The TEFRA loan rules generally apply to loans made after August 13, 1982. Under a special transitional rule, however, a qualified refunding loan made after August 13, 1982, and before August 14, 1983, generally is not treated as a distribution on the date of the loan. A qualified refunding loan is a loan used to make a required principal payment on a loan that was outstanding on August 13, 1982, if that payment is required to be made before August 14, 1983.

Explanation of Provision

The bill clarifies that the 50-percent loan limit does not reduce the overall limit on loans below $10,000. Accordingly if, immediately after a loan, the outstanding loan balance is less than $10,000, the new loan rules would not cause the loan to be treated as a distribution even though the outstanding loan balance at that time exceeds 50 percent of the employee's nonforfeitable accrued benefit under the plan. TEFRA did not change prior law under which certain loans could be treated as distributions.

In addition, the bill provides that a loan to an employee from deductible employee contributions is treated as a distribution under the plan, regardless of the amount of the loan. In addition, the present value of an employee's nonforfeitable accrued benefit under the plan would not include any accrued benefit attributable to deductible employee contributions.

The bill repeals the provision that treats a repayment of a loan to an owner-employee as a contribution to the plan on behalf of the owner-employee.

Further, the bill clarifies the special transitional rule for qualified refunding loans by defining a required principal payment to include an amount paid under a loan payable on demand if the loan was outstanding on August 13, 1982.

16. Repeal of special qualification requirements (sec. 613(c) of the bill and secs. 72 and 402 of the Code)

Present Law

TEFRA generally eliminated distinctions in the tax law between qualified pension, etc., plans of corporations and those of self-employed individuals (H.R. 10 plans). TEFRA (1) repealed certain of the special rules for H.R. 10 plans, (2) extended other of the special rules to all qualified plans, including those maintained by corporate employers, and (3) generally applied the remainder of the special rules, with modifications, only to those plans (whether maintained by a corporate or noncorporate employer) that favor the employer's key employees (i.e., top-heavy plans).

TEFRA provided that a distribution to an individual who is (or was) a key employee and who has not attained age 59 1/2 or become disabled is subject to an additional 10-percent income tax. This additional tax is imposed on the income portion of a distribution attributable to accumulations or accruals made when the individual was a key employee in a top-heavy plan.

Explanation of Provision

The bill clarifies that the additional 10-percent income tax for distributions prior to age 59 1/2 is not to apply to a distribution to an owner-employee unless it is attributable to contributions paid on behalf of the individual while a key employee in a top-heavy plan.

The bill amends the rules relating to qualifying rollover distributions to provide that a rollover to a qualified pension, etc., plan is not permitted if any part of the distribution of a benefit is attributable to contributions made on behalf of the employee while a key employee in a top-heavy plan. The rule is necessary because of special restrictions that apply to these benefits. If a distribution to a self-employed individual is not attributable to contributions made while the individual was a key employee in a top-heavy plan, however, a rollover to a qualified pension, etc., plan or a qualified annuity plan is permitted.

17. Repeal of special limitations on deduction for self-employed individuals and subchapter S corporations (sec. 613(d) of the bill and secs. 72, 219, 401, 404, and 415 of the Code)

Present Law

TEFRA generally repealed most of the special deduction limits for contributions on behalf of a self-employed individual under a qualified defined contribution H.R. 10 plan, effective for taxable years beginning after December 31, 1983. In addition, TEFRA revised the definition of earned income of a self-employed individual so that the amount of earned income corresponds to the amount of compensation of a common-law employee. Under TEFRA, in applying the rules on deductions and limitations for qualified plans, the earned income of a self-employed individual is computed after taking into account contributions by the employer to a qualified plan to the extent a deduction is allowed for the contributions.

TEFRA repealed the special rules applicable to qualified defined benefit pension plans providing benefits for self-employed individuals or shareholder-employees of a subchapter S corporation, effective for plan years beginning after December 31, 1983.

TEFRA revised the dollar limit ($30,000 for 1984) on employer contributions to a simplified employee pension (SEP) to correspond to the dollar limit on annual additions under a qualified defined contribution plan. TEFRA, however, did not increase the limit on employee deductions ($15,000) to conform with the higher limit on employer contributions.

Explanation of Provision

The bill provides that, for purposes of determining the maximum allowable deduction of a self-employed individual for contributions to a qualified plan, the earned income of the self-employed individual is determined without regard to the deductions allowable for contributions to a qualified pension, etc., plan.

The bill amends the effective date of the repeal of the special deduction rules for defined contribution H.R. 10 plans to clarify that the rules do not apply to a qualified defined benefit H.R. 10 plan.

The bill amends the limit on deductions by employees for employer contributions to SEPs to conform with the dollar limit on annual additions to qualified defined contribution plans. Accordingly, the bill raises the dollar limit on employee deductions to $30,000.

The bill also repeals the following provisions relating to self-employed individuals:

(1) the rule relating to the return of excess contributions made on behalf of a self-employed individual prior to the due date of the annual return;

(2) the special limit on contributions by an employer on behalf of an owner-employee to pay premiums or other consideration for an annuity, endowment, or life insurance contract on the life of the owner-employee issued under an H.R. 10 plan;

(3) certain special deduction rules applicable to plans benefiting self-employed individuals or shareholder-employees; and

(4) the special limitation applicable to certain level premium annuity contracts under plans benefiting owner-employees.

18. Allowance of exclusion of death benefit for self-employed individuals (sec. 613(e) of the bill and sec. 101 of the Code)

Present Law

TEFRA provided that the exclusion from gross income of amounts received as death benefits by the beneficiary or estate of an employee is available with respect to any lump sum distribution under a qualified pension, etc., plan, a qualified annuity plan, or a tax-sheltered annuity paid on behalf of a self-employed individual.

Explanation of Provision

The bill provides that the exclusion from gross income of employee death benefits provided on behalf of a self-employed individual generally applies to amounts paid or distributed under a qualified pension, etc., plan. The bill would not change the rule providing that the exclusion is not available if (1) the employee (or self-employed individual) possessed, immediately before death, a nonforfeitable right to receive the amounts while living and (2) the distribution is not a lump sum distribution.

19. Special rules for top-heavy plans (sec. 613(f) of the bill and secs. 408 and 416 of the Code)

Present Law

TEFRA provided additional qualification requirements for plans that favor an employer's key employees (top-heavy plans). These additional requirements (1) limit the amount of a participant's compensation that may be taken into account, (2) provide greater portability of plan benefits for plan participants by requiring more rapid vesting, (3) provide minimum nonintegrated contributions or benefits for plan participants who are not key employees, and (4) reduce the aggregate limit on contributions and benefits for certain key employees.

An individual is a key employee of an employer if the individual is a participant in an employer plan and, at any time during the plan year or any of the four preceding plan years, (1) is an officer (in the case of a corporate employer), (2) is one of the 10 employees owning the largest interests in the employer, (3) owns more than a 5-percent interest in the employer, or (4) owns more than a 1-percent interest in the employer and has compensation from the employer in excess of $150,000.

For any plan year for which a plan is a top-heavy plan, only the first $200,000 of any employee's compensation may be taken into account under the plan. Beginning in 1986, this $200,000 limit will be adjusted for inflation in the same manner applicable to the adjustment of the overall dollar limits on contributions and benefits under qualified pension, etc., plans.

Under TEFRA, a defined benefit pension plan is a top-heavy plan for a plan year if, as of the determination date, the present value of the cumulative accrued benefits for participants who are key employees for the plan year exceeds 60 percent of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan is a top-heavy plan for a plan year if, as of the determination date, the sum of the account balances of participants, who are key employees, for the plan year exceeds 60 percent of the sum of the account balances of all employees under the plan.

If a plan is a member of a group of plans that is required to be aggregated for purposes of the rules for top heavy plans, the plan's status is determined by the status of the group. Accordingly, if the plan is a member of a group that is not top heavy, no plan in the group is top heavy even though the particular plan, standing alone, would be top heavy. Similarly, if the group is top heavy, each plan in the group is top heavy even though the particular plan, standing alone, is not top heavy.

Under a 5-year lookback rule, the present value of the cumulative accrued benefit of a participant in a defined benefit pension plan or the account balance of a participant in a defined contribution plan generally includes any amount distributed with respect to the participant under the plan within the five-year period ending on the determination date (including lump-sum distributions and distributions made before the date of enactment or before the plan became top-heavy).

Explanation of Provision

The bill revises the definition of a key employee to include any employee, rather than any participant in an employer plan, who has the requisite relationship to the employer. An employee includes a former employee who must be considered under the five-year lookback rule. In addition, the bill provides that, for purposes of determining the ten employees owning the largest interests in the employer, (1) only employees with annual pay in excess of the dollar limit for the year on annual additions to qualified defined contribution plans ($30,000 for 1984) are taken into account as key employees and (2) if two employees have the same interest in the employer, the employee with greater annual compensation is treated as having a larger interest. Further, the bill clarifies that the determination of the amount of an employee's interest in an employer for purposes of determining the top-ten owners, 5-percent owners, or 1-percent owners is determined without regard to the aggregation rules of sections 414(b), (c), or (m).

Under the bill, the requirement that the employer make a minimum contribution on behalf of each participant who is not a key employee applies to a SEP if the SEP arrangement is top-heavy.

The bill clarifies that distributions under a terminated plan are taken into account under the 5-year lookback rule in determining the top heavy status of plans maintained by an employer.

The bill provides that the $200,000 limit on compensation taken into account under SEPs will be adjusted for inflation at the same time and in the same manner as the adjustments to the overall dollar limit on annual additions under a qualified defined contribution plan. In addition, the bill clarifies that no adjustment will be made to the $200,000 limit on compensation taken into account under the rules for top-heavy plans until adjustments are made to the overall dollar limits on contributions and benefits.

20. Employee leasing (sec. 613 of the bill and sec. 414 of the Code)

Present Law

Under present law, for purposes of certain of the tax-law rules for qualified pension, profit-sharing, or stock bonus plans and simplified employee pensions, certain leased employees are treated as employees of the lessee. Present law includes a safe harbor rule under which the leased employee is not treated as the employee of the lessee if certain requirements are met.

The committee is aware that some individuals have interpreted the present law safe harbor rules as overriding traditional common-law employee rules. The committee believes that present law should be clarified to prevent this interpretation.

Explanation of Provision

The provision clarifies the present law definition of a leased employee to include those individuals who are not otherwise employees of the lessee.

21. Required distributions for qualified plans (sec. 613(g) of the bill and sec. 401 of the Code)

Present Law

TEFRA extended to all qualified plans the requirement that the entire interest of an employee must be distributed not later than (1) the taxable year in which the participant attains age 70-1/2, or (2) if later, the year in which the participant retires. Alternatively, distributions must begin no later than such taxable year and must be made, pursuant to Treasury regulations, over the life of the participant (or lives of the participant and the participant's spouse), or over a period not exceeding the life expectancy of the participant (or the life expectancies of the participant and the participant's spouse). In addition, a top-heavy plan must provide that distributions to an individual who is a key employee will commence not later than the taxable year in which the key employee attains age 70-1/2 whether or not the key employee separates from service or applies for benefit payment in that year. Under present law, the entire interest of an employee does not include death benefits that are excluded from a beneficiary's gross income under section 101.

TEFRA extended to all qualified plans certain rules for post-death distributions. If a participant or the participant's surviving spouse dies before the entire interest in the plan is distributed, amounts payable to a beneficiary who is not the participant's surviving spouse generally must be paid to the beneficiary within five years after the participant or surviving spouse dies. The required distribution rules generally apply for plan years beginning after December 31, 1983. A special transition rule, however, exempts certain distributions made pursuant to employee designations if the designation is made before January 1, 1984.

Explanation of Provision

The bill clarifies that, for purposes of the rules requiring distributions before death, distributions may be made to the participant and a nonspouse beneficiary even though the measuring lives for a permissible payment period are those of the participant or the participant and spouse.

Under the bill, an exception is provided to the general rule requiring distributions to be paid within five years after the death of an employee or an employee's surviving spouse. Under the bill, the 5-year limit does not apply if the distribution commences not later than one year after the death of the employee or the employee's surviving spouse and is paid to a qualified beneficiary. Under Treasury regulations, payments must be made over a qualified period.

In general, the bill provides that a qualified beneficiary includes any individual who (1) was a dependent (sec. 152) of the employee or the employee's surviving spouse for any two of the last five taxable years, or (2) is a former spouse of the employee. For purposes of determining dependency, if a child's parents are divorced, and the child is a dependent of either or both of the divorced parents, then the child is treated as a dependent of each divorced parent. Also, social security benefits paid to a beneficiary are disregarded.

The Committee intends that a plan administrator may rely in good faith on the written representations of a beneficiary as to the beneficiary's status as a dependent or former spouse.

The qualified period over which payments may be made to a qualified beneficiary generally does not end before the later of (1) five years after the date of death of the decedent, or (2) the life expectancy of an individual with an age equal to the age of the decedent at the time of death. Payments to a beneficiary who is permanently and totally disabled may be paid over the life expectancy of the beneficiary or a term certain not extending beyond the life expectancy of the beneficiary. Under the bill, in the case of a qualified beneficiary who is under age 22 at the time of the employee's death, payments need not commence prior to the time the beneficiary attains age 22 and the qualified period does not, in any case, end before the beneficiary attains age 27. The same rules apply if the benefits are payable after the death of the employee's spouse.

The bill provides that the special transition rule for employee designations does not expire until the first day of the first plan year beginning on or after January 1, 1984. In addition, the bill would clarify that if a plan provides for a specific method of distribution in the absence of an employee election of another method, such a default option is treated as an employee designation under the special transition rule. This default option is treated as an employee designation even if there is only one method of distribution permitted under the plan. Further, in the case of a collectively bargained plan, the transition period for employee designations does not expire until the first day of the first plan year beginning on or after the earlier of (1) the date on which the last of the collective bargaining agreements relating to the plan terminates or (2) January 1, 1986.

Under the bill, in the case of a government plan, the effective date is delayed until plan years beginning after December 31, 1985, in order to provide adequate time for the employer to amend the plan. Corresponding changes are made to the expiration date of the special transition rule.

22. Required distributions in case of individual retirement plans (sec. 613(h) of the bill and sec. 408 of the Code)

Present Law

TEFRA revised the rules relating to distributions from an individual retirement account or annuity (IRA) after the death of the individual on whose behalf the IRA was established. In addition, TEFRA repealed the rules under which any beneficiary of an individual on whose behalf an IRA was established (or any beneficiary of the surviving spouse of such an individual) effectively could elect to treat the inherited IRA as one established on the beneficiary's own behalf.

The TEFRA provision relating to the treatment of inherited IRAs is effective for taxable years beginning after December 31, 1983.

Explanation of Provision

The bill clarifies that the provision applies with respect to individuals dying after December 31, 1983.

23. Existing personal service corporations liquidating in 1983 or 1984 (sec. 613(i) of the bill and sec. 247 of TEFRA)

Present Law

TEFRA provided a transitional rule under which personal service corporations may, during 1983 or 1984, complete a one-month liquidation under section 333 without the corporation incurring tax on its unrealized receivables.

Explanation of Provision

The bill clarifies that this transition rule is available only to corporations that were in existence on September 3, 1982 (the date of enactment of TEFRA).

24. Nondiscriminatory coordination of defined contribution plans with OASDI (sec. 613(j) of the bill and sec. 408 of the Code)

Present Law

TEFRA extended to all defined contribution plans a prior-law rule for qualified H.R. 10 plans under which the tax rate and wage base applicable to employers for old age, survivors, and disability insurance (OASDI) under social security are the maximum rate and base for determining the amount by which employer contributions can be reduced under qualified plans that are integrated with social security.

Explanation of Provision

The bill provides that, if an employer does not maintain an integrated plan at any time during the taxable year, OASDI contributions may be taken into account as contributions by the employer to an employee's simplified employee pension (SEP). This rule applies, however, only if OASDI contributions are taken into account with respect to each employee maintaining a SEP.

25. Profit-sharing plan contributions on behalf of disabled employees (sec. 613(k) of the bill and sec. 415 of the Code)

Present Law

TEFRA permitted an employer to elect to continue deductible contributions to a profit-sharing plan on behalf of an employee who is permanently and totally disabled. The contributions are deductible, however, only if contributions are nonforfeitable when contributed.

Explanation of Provision

The bill clarifies that the election is available for contributions to profit-sharing and stock bonus plans. In addition, the bill clarifies that only those contributions that are the subject of the employer's election must be nonforfeitable when made under the special rule.

26. Attorney's fees (sec. 614(b) of the bill and sec. 7430 of the Code)

Present Law

TEFRA added provisions allowing awards of attorney's fees to taxpayers under certain circumstances in tax cases commenced after February 28, 1983, in any United States court or the Tax Court. On October 1, 1982, (after enactment of TEFRA), the U.S. Court of Claims was reorganized, creating a new United States Claims Court as an Article I court. Because of this reorganization, the question has arisen whether the Claims Court is a "court of the United States" for purposes of the attorney's fee provisions.

Explanation of Provision

The bill clarifies that the attorney's fee provisions of TEFRA apply in tax cases in the Claims Court.

27. Withholding on pensions, annuities, and certain other deferred income (sec. 614(c) of the bill and secs. 31, 3405, and 6652 of the Code)

Present Law

TEFRA provided that payors generally are required to withhold tax from a designated distribution (the taxable part of a payment made from or under a pension, profit-sharing, stock bonus, or annuity plan, an IRA, a commercial annuity contract, or an employer deferred compensation plan if the distribution is not otherwise considered wages). Recipients may elect, for any reason, not to have the withholding rules apply to any distribution. Payors are required to notify recipients of their right to elect not to have the withholding rules apply.

Explanation of Provision

The bill provides a credit against income tax for the amounts withheld under the pension withholding provisions.

Under the bill, no amount would be required to be withheld if a distribution consists only of employer securities of the employer corporation and cash in lieu of fractional shares of employer securities. The amount of cash received in the distribution may not exceed $200. The bill clarifies that the taxable part of a nonperiodic distribution paid by reason of death under a qualified pension, etc., plan, or a tax-sheltered annuity, is determined by taking into account the $5,000 death benefit exclusion provided in section 101(b), whether or not the exclusion is allowable.

The bill clarifies that the pension withholding rules do not apply to amounts paid to nonresident aliens if the amounts are subject to the withholding of tax on nonresident aliens or would be subject to such withholding but for a tax treaty. Further, the bill provides a penalty for failure to give the notice to recipients required under the pension withholding rules. The penalty applies unless it is shown that the failure is due to reasonable cause and not willful neglect. The penalty is equal to $10 for each failure, up to a maximum during any calendar year of $5,000.

28. Partnership audit (sec. 614(g) of the bill and sec. 6233 of the Code)

Present Law

The tax treatment of any partnership item, under the rules adopted in TEFRA, is required to be determined at the partnership level. A comparable requirement applies in the case of subchapter S corporations. A partnership return or an S corporation may be filed for a taxable year and it may thereafter be determined that the filing entity is not a partnership or an S corporation, respectively, or that there is no entity for the taxable year with respect to which the return was filed.

Explanation of Provision

Under the bill, to the extent regulations provide, the partnership level determination requirement and the comparable requirement for S corporations apply when a partnership return or S corporation return, respectively, is filed, although it is thereafter determined that the filing entity was not a partnership or S corporation, or that no entity existed for the taxable year as to which the return was filed.

29. Clerical amendments

Amendments are also made to correct several clerical errors and correct cross references.

B. Technical Corrections to the Subchapter S Revision Act of 1982

1. Corporate liquidations, etc. (sec. 621(a) of the bill and proposed sec. 1363(e) of the Code)

Present Law

The Subchapter S Revision Act of 1982 (the "Act") provided that gain is recognized on the distribution of appreciated property by an S corporation with respect to its stock. The committee reports state that this rule does not apply in the case of a complete liquidation.

Explanation of Provision

The bill adds clarifying language making this rule inapplicable in the case of a complete liquidation of an S corporation, or to the distribution of stock by an S corporation in a reorganization where the receipt of that stock is tax-free to the shareholder (by reason of sec. 354, 355, or 356). It is intended both that a liquidating distribution by an S corporation will be a nonrecognition transaction (under sec. 336) at the corporate level, and also that the nonrecognition provisions of section 337 will continue to apply to the sale or exchange of property after a plan of complete liquidation has been adopted by an S corporation.

As under present and prior law, gain or loss will be recognized by the shareholder with respect to his or her S corporation stock on receipt of a distribution in complete liquidation (under the rules of secs. 331 or 333). The amount of gain or loss recognized to the shareholder will not be affected by any gain or loss which is not recognized at the corporate level.

2. Treatment of discharge of indebtedness (sec. 621(b) of the bill and sec. 108 of the Code)

Present Law

Generally, a taxpayer realizes income when its debts are discharged at less than the face amount of the debt. However, if the debt was incurred by a corporation, the taxpayer may elect to reduce certain tax attributes in lieu of recognizing income.

Explanation of Provision

In order to treat all shareholders in the same manner, the bill provides that the exclusion of income arising from discharge of indebtedness and the corresponding reductions in tax attributes (including losses which are not allowed by reason of any shareholder's basis limitation) are made at the corporate level. Also, the bill provides that where a debt is contributed to an S corporation by a shareholder as a contribution to capital after December 31, 1980, corporate income will not result to the extent that the basis of the debt had previously been reduced by the pass-through of losses from the corporation (under present or prior law).

3. Treatment of inactive subsidiaries (sec. 621(c) of the bill and sec. 1361(c)(6) of the Code)

Present Law

Under present law, an S corporation may not own a subsidiary corporation other than an inactive subsidiary. An inactive subsidiary is defined as a corporation which has not begun business before the close of the taxable year and which has no taxable income for the period included within the S corporation's taxable year.

Explanation of Provision

The bill eliminates the taxable income test and instead would provide that a subchapter S election would terminate, by reason of the subsidiary becoming active, on the first day during the S corporation's taxable year that the subsidiary has gross income. This rule prevents a termination of the subchapter S election from occurring retroactively to the beginning of the taxable year (which is generally prohibited) by reason of the subsidiary having any taxable income. For purposes of applying this gross income test, contributions to the corporation's capital by a shareholder are not to be treated as gross income.

4. Treatment of worthless debt (sec. 621(d) of the bill and sec. 1367(b) of the Act)

Present Law

The Act provided that corporate losses which pass through to the shareholders are to be taken into account prior to taking into account the deduction for worthless stock.

Explanation of Provision

The bill provides the same rule where the shareholder's debt in the corporation becomes worthless. Thus, for example, where a shareholder has no basis in his or her S corporation stock but has basis in debt owed by the corporation and that debt becomes worthless, corporate losses for the year will be allowed to the shareholder; these losses will reduce the shareholder's basis in the debt, which in turn will reduce the amount of the short-term capital loss (under sec. 166(d)) for the worthless debt.

5. Investment tax credit recapture (sec. 621(e) of the bill and sec. 1371(d) of the Code)

Present Law

The Act provided that the recapture of the investment tax credit for credits claimed in years prior to becoming an S corporation is to be made at the corporate level.

Explanation of Provision

The bill clarifies that an S corporation's accumulated earnings and profits will be reduced by the amount of investment credit recapture tax (sec. 47) imposed on the corporation with respect to these credits, since the earnings and profits were not previously reduced by the amount of tax savings attributable to the credit.

6. Qualified subchapter S trusts (sec. 621(f) of the bill and sec. 1361(d) of the Code)

Present Law

Present law allows certain trusts which distribute, or are required to distribute, income currently to elect to be treated as a "qualified subchapter S trust" which may be a shareholder in an S corporation. This election may be retroactive for up to 60 days.

Explanation of Provision

The bill increases this period to 75 days, to generally conform to the time provided the corporation to make a subchapter S election. Also, the bill clarifies that the disqualification of a trust by reason of the failure to meet the distribution requirements will be effective on the first day of the first taxable year after this requirement is not met.

7. Accounting treatment where election terminates (sec. 621(g) (h) and (t) of the bill and sec. 1362 of the Code)

Present Law

Under present law, the items of income, loss, etc. for the entire taxable year in which a subchapter S election is terminated are pro-rated between the short subchapter S year and the short regular corporate year on a daily basis, unless all persons who are shareholders at any time during the year consent to closing the corporate books at the end of the subchapter S year.

Explanation of Provision

The bill provides that the election to "close the books" may be made if all the shareholders owning stock during the short subchapter S year and all shareholders owning stock on the first day of the short subchapter C year consent to the election. Also, under the bill, if a corporation makes a qualified stock purchase of the stock of an S corporation and makes an election under section 338, all the recapture income resulting from the election will be reported in the corporation's subchapter C return. As a result, the selling shareholders will not take this recapture into account on their individual returns.

8. Passive income rules for 1982 (sec. 621(i) of the Code and sec. 6(b) of the Act)

Present Law

Under the Act, the amendments to the passive income rules, preventing a subchapter S election from terminating by reason of excess passive income for any single taxable year, were made effective for taxable years beginning after December 31, 1981.

Explanation of Provision

The bill provides that a corporation can elect to have the new passive income rules apply only for taxable years beginning after December 31, 1982, the general effective date for the Act. Thus, a corporation with excess passive income under the rules of prior law for its taxable year beginning in 1982 can elect to terminate its subchapter S election rather than paying both a corporate and shareholder tax on that income. If an election under this provision is made causing the termination of the subchapter S election, the corporation cannot re-elect subchapter S status within 5 years without the consent of the Internal Revenue Service.

9. Attribution (sec. 621(j) of the Act and sec. 318 of the Code)

Present Law

Under present law, in applying attribution of ownership rules under section 318, a partnership is deemed to own proportionately stock owned by the partnership, and the partnership is deemed to own all the stock owned by the partners. In the case of a corporation, attribution to and from shareholders occur only with respect to shareholders owning 50 percent or more in value of the corporation's stock.

Explanation of Provision

The bill provides that the attribution of stock to or from an S corporation and its shareholders would apply in the same manner as if the S corporation (and its shareholders) were a partnership (with partners). Thus, attribution will occur to and from shareholders owning less than 50 percent of the corporation's stock.

10. Certain short taxable years (sec. 621(l) of the bill and sec. 1362(b) of the Code)

Present Law

Under present law, a subchapter S election for a taxable year may be made during the first 2 1/2 months of the taxable year (sec. 1362(b)(1)(B)).

Explanation of Provision

The bill provides that a corporation can make the election within 2 1/2 months from the beginning of a taxable year although the taxable year is of less than 2 1/2 months duration.

11. Taxable year of existing S corporations (sec. 621(m) of the bill and sec. 1378 of the Code)

Present law

Under present law, an S corporation which had an election in effect for a taxable year which includes December 31, 1982, may not retain that taxable year after there has been a change in ownership of more than 50 percent of the stock after December 31, 1982. Acquisition by reason of death, gift or certain buy-sell agreements are not treated as change in ownership.

Explanation of provision

The bill clarifies that the ownership change rules apply to any corporation which made an election before October 19, 1982, where that election was effective for a taxable year beginning in 1983. The bill also clarifies that stock held by an estate of a decedent on December 31, 1982, may qualify as stock acquired by reason of death, for purposes of the change in ownership rules.

12. Distributions during post-termination period (sec. 621(o) of the bill and sec. 1371(e) of the Code)

Present law

Under present law, a distribution of cash by a corporation during a period generally one year from the date an S corporation election terminates is tax-free to the extent of amounts in an accumulated adjustments account (generally undistributed S corporation income).

Explanation of provision

The provision will allow corporations to elect to treat distributions as dividends during this post-termination period. This will allow a corporation to pay dividends to avoid accumulated earnings tax or personal holding company tax.

13. Corporate preference items (sec. 621(p) of the bill and sec. 291 of the Code)

Present law

Under present law, S corporations compute their taxable income as an individual, and therefore the provision relating to corporate preference items does not apply to an S corporation.

Explanation of provision

In order to prevent a regular corporation from avoiding the corporate preference rules by making an S corporation election, the bill provides that the corporate preference rules will apply for the first three taxable years after a regular corporation elects subchapter S status. The rules will not apply to any corporation which has been an S corporation for all its taxable years.

14. Accumulated adjustments account (sec. 621(r) of the bill and sec. 1368(e) of the Code)

Present law

Under present law, S corporations generally may make tax-free distributions to the extent the distributions do not exceed the amount in an accumulated adjustments account. This account generally reflects the accumulated net income of the corporation less prior distributions.

Explanation of provision

The bill provides that S corporation losses for any taxable year may cause the account to become negative so that future income may cause the account to become positive only after the negative balance has been restored.

The bill also provides that non-deductible amounts which are not related to the production of income which is exempt from tax will reduce the amount in the account.

Finally, the bill provides that for any taxable year, the amount in the account (after taking into account income and loss for the taxable year) will be used up pro rata among all distributions made during the year. Thus, if the account balance at the end of a year, before distributions, is $100 and the corporation distributed $200 during the taxable year, one-half of each distribution will be treated as from the accumulated adjustments account and therefore will not be taxed as a dividend.

15. Clerical amendments

The bill also makes several clerical amendments to the Act.

C. Technical Corrections to Miscellaneous Provisions

1. Tax preference for low-income housing (sec. 622(a)(1) of the bill and sec. 57 of the Code)

Present Law

The Technical Corrections Act of 1982 added a provision to clarify that the amortization of low-income housing under section 167(k) remained a tax preference, but erroneously added that provision to subparagraph (A) of section 57(a).

Explanation of Provision

This bill moves that provision to subparagraph (B) of section 57(a), relating to the tax preference for 15-year real property.

2. Foreign currency contracts (sec. 622(a)(2) and (4) of the bill and sec. 1256(g) of the Code)

Present Law

The Technical Corrections Act of 1982 provided that certain foreign currency contracts entered into after May 11, 1982 (or earlier, if certain elections were made) will be treated as regulated futures contracts and therefore be taxed on the marked-to-market system with a maximum tax rate of 32 percent. In order for a contract to qualify as a foreign currency contract, the contract must require delivery of a foreign currency which is a currency in which positions are also traded through regulated futures contracts.

Explanation of Provision

Because certain contracts may call for a cash settlement by reference to the value of the foreign currency rather than actual delivery of the currency, the bill provides that the delivery of a foreign currency requirement is met where the contract provides for a settlement determined by reference to the value of the foreign currency.

The bill also permits taxpayers to elect to have the regulated futures contract rules apply only to contracts entered into after January 12, 1983, the date of enactment of the Technical Corrections Act of 1982.

3. Effective date of corporation acquisition provision (sec. 622(a)(3) of the bill and sec. 306(a)(8) of TEFRA)

Present Law

The Technical Corrections Act of 1982 clarified that any recapture income required to be reported as the result of an election to treat the purchase of corporate stock as the sale and purchase of the corporate assets generally is not reported on a consolidated return. Instead, the income is reported on the target corporation's separate return. The new TEFRA provision allowing an election to treat stock purchases as asset purchases was effective for purchases on or after September 1, 1982. A transitional rule was provided by the Technical Corrections Act to require reporting of the recapture income on the selling corporation's consolidated return in circumstances where the contract was negotiated on the contemplation that the recapture income would be reported on the selling corporation's consolidated return, and where the stock was purchased pursuant to a binding contract entered into on or after the date of enactment of TEFRA (September 3, 1982) and before the date of enactment of the Technical Corrections Act. The transitional rule is inapplicable where the contract was entered into before September 3, 1982, notwithstanding that it was contemplated that the new TEFRA rules would apply.

Explanation of Provision

The bill makes the special transitional rule requiring recapture income to be reported on a selling corporation's consolidated return applicable to contracts entered into on or after September 1, 1982 (the effective date of the TEFRA election provision), rather than on or after September 3, 1982 (the date TEFRA was enacted into law).

4. Coordination of certain amendments made by the Highway Revenue Act of 1982 and Public Law 97-473 (sec. 622(b) of the bill)

Present Law

The Highway Revenue Act of 1982 revised Code section 103(m) to clarify that interest on certain obligations is tax exempt under section 103 and that therefore the shareholders of regulated investment companies holding those obligations qualify for tax-free treatment on the distributions of the interest on those obligations. Public Law 97-473 also revised old section 103(m) to provide cross references. Because the Highway Act was signed prior to P.L. 97-473, the question arises whether the provision relating to Code section 103(m) contained in the Highway Act was repealed by the later-signed law.

Explanation of Provision

The bill clarifies that Public Law 97-473 did not repeal the exempt interest provision added by the Highway Revenue Act.

5. Principal campaign committees (sec. 622(c) of the bill and sec. 527(h) of the Code)

Present Law

Under present law, the principal campaign committee of a candidate for Congress is taxed by using the graduated corporate rates. The principal campaign committee is the committee designated by the candidate.

Explanation of Provision

The bill provides that if the candidate has only one campaign committee, that committee will be treated as the principal campaign committee without the necessity of a designation.

D. Technical Corrections to Highway Revenue Act of 1982

1. Application of retail truck and trailer excise tax to vehicles including used parts (sec. 631 of the bill and sec. 4052 of the Code)

Present Law

The Highway Revenue Act repealed the prior 10-percent manufacturers excise tax on certain trucks and trailers and imposed the tax as a retail excise tax. The new tax is imposed at a 12-percent rate on the first retail sale of taxable trucks and trailers.

Explanation of Provision

The bill clarifies that the value of any used component included in a taxable truck or trailer (if furnished by the first user of the taxable vehicle) is excluded in determining the retail price of (and thereby the excise tax on) the truck or trailer.

2. Application of gasoline excise tax to gasohol (sec. 632 of the bill, secs. 4081(c) and 6427 of the Code, and sec. 521(a) of the Act)

Present Law

The Highway Revenue Act provides a 5-cents-per-gallon exemption for gasohol from the 9-cents-per-gallon gasoline excise tax.

Explanation of Provision

The bill clarifies that the exemption applies to the gasohol mixture, and not solely to the gasoline component of the mixture. A conforming amendment is made to the floor stocks tax imposed on certain gasohol held for sale on April 1, 1983.

3. Certain chain operators of retail gasoline stations treated as producers (sec. 633 of the bill and sec. 4082(d) of the Code)

Present Law

The Highway Revenue Act imposed a tax of 9 cents per gallon on the sale of gasoline by a producer or importer. For purposes of this tax, the term "producer" includes wholesale distributors who (1) sell gasoline to producers, to retailers, or to users who purchase the gasoline in bulk quantities for delivery into bulk storage tanks and (2) who elect to be so treated. These distributors (jobbers) may purchase gasoline tax-free for sale to independent dealers.

Explanation of Provision

The bill provides that, for purposes of the gasoline tax, wholesale distributors include chain operators who (1) purchase gasoline from a producer and distribute the gasoline to 10 or more retail stations under common management with such operator and (2) who elect to be so treated. These distributors will be entitled to purchase gasoline tax-free for sale at the commonly-managed retail stations, the tax being imposed upon such later sale. For purposes of this rule, retail sale of the same brand of gasoline is not sufficient to indicate common management. This amendment is effective for sales after June 30, 1984.

4. Floor stocks refunds for tax-reduced tires (sec. 634(a) of the bill and sec. 523(b) of the Highway Revenue Act)

Present Law

The Highway Revenue Act provides for refund of certain previously-paid manufacturers excise taxes on articles on which tax is repealed.

Explanation of Provision

The bill clarifies that floor stocks refunds also are available with respect to tires on which the excise tax is reduced, but not repealed, on January 1, 1984. The refund is limited to the reduction in tax.

5. Collection of excise tax on noncommercial aviation gasoline (sec. 634(c) of the bill and new secs. 4082(e) and 6427(j) of the Code)

Present Law

Present law provides for a tax of 12 cents per gallon on gasoline used in noncommercial aviation aircraft. The tax consists of two parts: a 9-cents-per-gallon tax on gasoline collected at the manufacturer's level (sec. 4081) plus a 3-cents-per-gallon tax collected at the retail level (sec. 4041(c). A tax of 14 cents per gallon on nongasoline fuels (e.g., jet fuel) used by noncommercial aviation is collected at the retail level.

Explanation of Provision

The bill provides that, effective on July 1, 1984, the 12 cents per gallon excise tax on gasoline used in noncommercial aviation aircraft shall be collected at the retail level effective January 1, 1984. The aviation gasoline dealer (under new sec. 4082(e)) is to be treated as a "producer" of gasoline and thus able to purchase such gasoline tax-free from the gasoline manufacturer or producer. An aviation gasoline dealer includes any person who regularly sells gasoline to owners, lessees, or operators of aircraft for use as fuel in such aircraft in noncommercial aviation.

An aviation gasoline dealer must register with the IRS in order to purchase gasoline tax-free. If the gasoline is later used or resold as fuel for other than noncommercial aviation aircraft, the user or seller must then pay the appropriate tax (i.e., 9 cents per gallon tax if used in a highway motor vehicle or in a motorboat).

6. Floor stocks refunds for retread tires (sec. 634(d) of the bill, sec. 523(b) of the Highway Revenue Act, and sec. 4072 of the Code)

Present Law

The Highway Revenue Act repeals, effective January 1, 1984, the tax of 5 cents per pound on tread rubber used in recapping or retreading highway tires. The Act provides for floor stocks refunds with respect to tread rubber on which the tax was previously paid and which remains in inventory on December 31, 1983.

Explanation of Provision

The bill provides that tread rubber which has been placed on retread tires prior to January 1, 1984, qualifies for a floor stocks refund. Only one such refund per tire may be received.

7. Other technical and conforming changes (secs. 634 (b), (c), and (e)-(h) and 635 of the bill, secs. 513(c), 521(c), and 523(b) of the Highway Revenue Act, and secs. 4051, 4053, 4061, 4063, 4071, 4073, 4082, 4216, 4218, 4221, 4227, 4481, 6412, and 6416 of the Code)

Explanation of Provisions

The bill restates as part of the new truck and trailer retail excise tax the exemptions previously provided under the repealed manufacturers excise tax.

The bill clarifies that refunds on tax paid on articles used as components in the manufacture of later articles are generally to be paid to the person who paid tax on the later article rather than the person who paid tax on the component.

The bill clarifies that the liability of installers for the truck and trailer retail excise tax on certain parts and accessories installed on taxable vehicles within six months of their purchase is secondary to the liability of the truck or trailer owners.

The bill clarifies that penalties applicable to the highway excise taxes also apply to the floor stocks taxes imposed by the Highway Revenue Act.

The bill clarifies two provisions relating to the heavy vehicle use tax. First, the bill clarifies that owner-operators eligible for a one-year delay in the increased heavy vehicle use tax rates will be subject to a full year's tax at the present law rates during 1984 (rather than a partial year's tax because of the previously scheduled expiration date of September 30, 1984). Second, the bill provides that no inference is to be drawn from the 1982 amendments with respect to the taxation of trailers based on their "customary use" for periods before the effective date of those amendments.

Further, the bill repeals provisions of the Code made obsolete by the Highway Revenue Act.

E. Technical Corrections to the Social Security Amendments of 1983 and Related Legislation

1. Foreign work test: Withholding from auxiliary on account of work performed by a retired worker (sec. 641(g) of the bill and secs. 203(d)(1) and (2) of the Act.)

Present law

The Social Security Amendments of 1983 (P.L. 98-21) changed the foreign work test to provide that a retirement, auxiliary, or survivor beneficiary will have his benefit withheld for each month in which he is under age 70 and works for more than 45 hours in noncovered remunerative activity outside the United States. However, the 7-day work test which applied to all beneficiaries under prior law continues to apply only with respect to withholding an auxiliary benefit because of work performed by the retired worker.

Explanation of provision

In order to avoid the anomalous situation of having two different foreign work tests, the bill provides that auxiliary benefits will be withheld due to noncovered work performed by a retired worker outside the United States on the same basis as primary benefits.

2. FICA treatment of employer pickup of employee contributions under State and local retirement plans (secs. 641(i)(2) and 643(i)(9) of the bill, sec. 209 of the Act, and secs. 3121 and 3306 of the Code)

Present Law

Prior to the Social Security Amendments of 1983, certain employer payments ("pickups") of employee contributions under a State or local retirement plan were treated as subject to FICA and FUTA only if the payments were made under a salary reduction arrangement. Under the Amendments, all such employer payments are subject to FICA and FUTA.

Explanation of Provision

Congress intended, in the Amendments, merely to codify the prior law treatment of employer pickups. Thus, the bill amends the provision so that employer pickups are taxable, for FICA and FUTA purposes, only if the pickup is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise). The term salary reduction agreement is not intended to include to cover those "agreements" which are mandated by state statutes.

3. Social Security coverage of Federal workers (secs. 641(j)(2) and 643(i)(4) of the bill and sec. 210(a)(5)(B) of the Social Security Act and sec. 3121(b)(5)(B) of the Code)

Present Law

The Social Security Amendments of 1983 provided social security coverage for newly hired Federal civilian employees effective with remuneration paid after December 31, 1983. Persons continuously in the employ of the United States since December 31, 1983 (or with a break in such employment of 365 days or less) will not be covered. Legislative branch employees are covered by social security unless they were covered by the Civil Service Retirement System on December 31, 1983.

Contrary to the intent of P.L. 98-21, several gaps and anomalies in this coverage are possible under current law. First, a person in Federal employment that is already covered (mainly the armed services, which have been covered since 1956) can retire from military service, enter Federal civilian service, and be exempt from social security. Second, a person who only technically severs his Federal civilian employment connection in order to serve a term of duty with an international organization would be treated as having had a break in service upon his return to domestic service, and would be covered under the new retirement system. Finally, legislative branch employees who were covered by CSRS on Dec. 31, 1983 could withdraw from CSRS after that date and not be covered by social security, while Federal employees covered by civilian retirement systems other than CSRS on Dec. 31, 1983 would be covered by social security if they transferred from the executive branch to the legislative branch. In addition, the use of the phrase "remuneration paid" in the effective date would have the effect of covering some 1983 earnings for which payment is not actually made until 1984, which was not the intent of the provision.

Explanation of Provision

In order to prevent Federal employees who had been previously covered under social security from losing coverage as a result of a break in service of less than 365 days, the bill provides that persons transferring from other government service to civilian service will be covered under social security, unless the other service was in an international organization, or the person is returning to civilian service after temporary military or reserve duty and is exercising his reemployment rights under chapter 43 of title 38, U.S.C. The bill also provides that legislative branch employees who were covered under either CSRS or another Federal civilian retirement system on December 31, 1983, but who have a break in service of less than a year after that date, will be covered by social security on their return or transfer to legislative employment, unless they elect coverage under CSRS within 45 days. The bill also corrects the effective date language to refer to "service performed" after December 31, 1983.

4. Basis for calculation of alternate annual cost-of-living adjustments (secs. 641(k)(4) and (5) of the bill and sec. 215(i)(5) of the Act)

Present Law

The Social Security Amendments of 1983 provided an alternative basis for the calculation of the annual cost-of-living adjustment to be paid in years when the trust fund balance is below a given percentage (15 percent at the beginning of years from 1985 through 1988, 20 percent thereafter). In any such year, the adjustment would be based on the lower of the CPI increase or the increase in average wages. The provision also requires that a "catch-up" payment be made at the point the trust funds again accumulate a reserve of at least 32 percent, to increase overall benefit levels to the extent necessary in order to compensate for losses resulting from the lower adjustment being paid. These payments can be made only to the extent that a fund ratio of at least 32 percent is maintained.

Due to a drafting oversight, the provision does not provide the authority necessary to round these catch-up payments in the same manner as all other social security benefits are rounded. The provision also could be interpreted as basing the calculation of the amount of the catch-up increase on a period of years including the year of the catch-up itself, rather than on the period ending with the year prior to the catch-up, as was intended and is stated elsewhere in the provision. In addition, the provision could be interpreted to allow a much higher catch-up payment than intended for persons who are eligible for retirement benefits long after the year of a lower benefit increase, but who were eligible for disability benefits during the year the lower increase was paid. Finally, the provision is not precise as to the description of the catch-up payment as an actual percentage.

Explanation of Provision

In order to clarify these ambiguities, the bill provides the necessary authority to round benefits, specifies that the catch-up payment will be based on the period of years preceding the year of the catch-up payment, and specifies that the calculation for an individual's entitlement to a catch-up payment is to be based on the year of eligibility for the benefit on which the catch-up increase is paid, and is to be cleraly expressed as a percentage.

5. Benefits of persons receiving pensions from noncovered employment (sec. 641(k)(1) of the bill and sec. 215(a) of the Act)

Present Law

The Social Security Amendments of 1983 provided for a different benefit formula to be used in computing social security benefits for persons receiving pensions from employment not covered by social security. Because of a drafting oversight, the language of the provision may result in exemption from the "windfall" formula of anyone who was eligible for any type of social security benefit at any time prior to eligibility for retirement benefits (e.g., during a brief period of disability.) Also, this language may result in unintended anomalous treatment of earnings for persons who work after age 62.

Explanation of Provision

The bill clarifies the definition of eligibility for the windfall benefit formula to make certain that all those becoming eligible for social security benefits after 1985 (provided they had not become eligible for their noncovered pension prior to that time) will have the new formula applied to them, and corrects the unintended, anomalous treatment of earnings after age 62.

6. Gender-based distinction concerning divorced husbands (sec. 641(l)(1) of the bill and sec. 216(f) of the Act)

Present Law

Under present law, a divorced woman is deemed to be divorced throughout the month in which she becomes divorced. Divorced husbands are not so deemed.

Explanation of Provision

While the Social Security Amendments of 1983 sought to eliminate all gender-based distinctions in the Social Security Act, this gender-based distinction was not eliminated by those Amendments. Consistent with the intention of the 1983 amendments, the bill deems a divorced husband to be divorced throughout the month in which he becomes divorced.

7. Financing of noncontributory military wage credits (sec. 641(n) of the bill and sec. 229(b) of the Act)

Present Law

The Social Security Amendments of 1983 changed the method of financing post-1956 noncontributory military wage credits by providing for a lump-sum payment to be made to the OASDHI trust funds from the general fund based on an amount estimated to be equivalent to the OASDHI employer-employee taxes attributable to such wage credits for the period 1957-83, accumulated with interest.

The law also provides that within 1 year after the date of the lump-sum transfer (which occurred on May 20, 1983), the amount is to be revised based on data which become available during that year. However, due to the timing of annual wage reporting, the actual amount of 1983 deemed military service wage credits will not become available until early in 1985 and, therefore, cannot be used to adjust the lump-sum amount.

The 1983 amendments also provided that in the future the trust funds would be paid annually for the OASDHI employer-employee taxes on deemed wage credits attributable to military service in years after 1983. These annual payments may be adjusted in subsequent years to account for actual experience but not for years before 1984. Thus, under current law, there will be no opportunity to revise the payment based on estimates of the amount of 1983 deemed wage credits in order to reflect actual experience.

Explanation of Provision

In order to ensure that the OASDHI trust funds are paid the correct amount for employer and employee taxes attributable to deemed military service wage credits for 1983, the bill delays the final adjustment of the estimated amount transferred to the trust funds based on deemed military service wage credits for 1983 by providing that the yearly authorizations of appropriations to the Social Security trust funds from the general fund may include adjustments of prior estimates for wages deemed to have been paid in 1983.

8. Effective date for elimination of gender-based distinction concerning entitlement of divorced husbands (sec. 642(d) of the bill and sec. 202(c) of the Act)

Present Law

The Social Security Amendments of 1983 provided that divorced spouses could become entitled to benefits without regard to the entitlement of their former spouses. Due to a drafting error, the provision applies to divorced husbands who become entitled to benefits after April 1983 and divorced wives who become entitled after December 1984.

Explanation of Provision

The bill corrects this discrepancy and eliminates this newly created gender-based distinction since P.L. 98-21 sought to eliminate all gender-based distinctions in the Act.

9. Effective date for treatment of certain deferred remuneration (sec. 642(g)(2) of the bill, secs. 3121 and 3306 of the Code, and sec. 209 of the Act)

Present Law

Under the Social Security Amendments of 1983, remuneration paid after services are performed, other than amounts paid under a qualified retirement plan, generally is taxable when paid, for FICA and FUTA purposes. Amounts deferred under nonqualified deferred compensation plans, however, are included in an employee's FICA and FUTA base when the services for which the amounts are payable are performed or, if later, when there is a lapse of a substantial risk of forfeiture of the employee's right to those amounts.

In general, the provision relating to certain deferred remuneration is effective for remuneration paid after December 31, 1983 (for FICA and social security benefit purposes), and after December 31, 1984 (for FUTA purposes). Under a grandfather rule, in the case of any agreement, in existence on March 24, 1983, between a nonqualified deferred compensation plan and an individual, the provision applies only with respect to remuneration paid that is attributable to services performed after December 31, 1983 (December 31, 1984, for FUTA purposes). As drafted, the treatment for FICA and social security benefit purposes is not clear, for example, for deferred compensation under an agreement not in existence on March 24, 1983, for services performed in 1983 and for which there is no substantial risk of forfeiture at some point during 1983. Further, the grandfather rule does not apply to payments under retirement or termination agreements, other than deferred compensation agreements, which may be qualified for exemption from FICA and FUTA under prior law.

Explanation of Provision

The bill makes two changes in the effective date of the above provisions of the 1983 Amendments. First, in order to eliminate the ambiguity in the tax treatment of nonqualified deferred compensation not subject to the grandfather rule, the bill provides that remuneration, which is paid after December 31, 1983 (December 31, 1984 for FUTA purposes) but would have been included in the definition of wages on or before that date if the provisions of the Social Security Amendments of 1983 had applied on or before that date, is included in the definition of wages when the remuneration is paid, or, at the election of the payor, at the time which would be appropriate if such amendments had applied. Thus, for example, if an individual enters into a nonqualified deferred compensation arrangement after March 24, 1983, and before January 1, 1984, the bill provides that with respect to services performed before January 1, 1984 deferred amounts for which risk of forfeiture lapses during 1983 are included in wages for FICA tax purposes when the amounts are paid after December 31, 1983, unless the payor elects to treat them as wages paid during 1983. Of course, the grandfather rule for certain agreements in existence on March 24, 1983, still applies to insure that remuneration attributable to services performed before January 1, 1984, and paid under these agreements continues to be subject to prior law.

Second, the bill extends the grandfather rule to apply to agreements in existence on March 24, 1983 between an individual and a plan or employer, if the agreement provided for making payments upon retirement which would have been excluded from tax under prior law. Thus, under the bill, if such an agreement was in existence on that date, prior law is applicable with respect to remuneration attributable to services performed before January 1, 1984, for FICA purposes (before January 1, 1985, for FUTA purposes).

10. Codification of Rowan decision (sec. 642(h) of the bill, secs. 3121 and 3306 of the Code, and sec. 209 of the Act)

Present Law

The Social Security Amendments of 1983 provided that, with the exception of the value of certain meals and lodging provided for the convenience of the employer, the determination of whether or not amounts are includible in the social security and FUTA wage bases is to be made without regard to whether such amounts are treated in regulations as wages for income tax withholding purposes. This provision thus prevents the application to compensation, other than meals and lodging, of the Supreme Court's reasoning in *Rowan Companies, Inc. vs. United States*, 452 U.S. 247 (1981). In this case, the Supreme Court held that, because the treatment of certain employer meals and lodging, excluded from gross income under section 119, for income tax withholding and for FICA purposes was not explicitly dealt with in the statutes governing these provisions, Treasury regulations defining wages for purposes of these two provisions had to be consistent. Thus, because one Treasury regulation excluded from wages for income tax withholding purposes the value of meals and lodging excluded from gross income under section 119, another regulation including these amounts in wages for FICA purposes was held to be invalid.

The provision in the Amendments applies to remuneration paid after December 31, 1983, for FICA and social security benefit purposes and to remuneration paid after December 31, 1984, for FUTA purposes. Thus, it is possible that this provision could be cited as demonstrating Congressional intent that the reasoning of the *Rowan* decision should generally apply before these dates to types of remuneration other than meals and lodging excluded under section 119, e.g., to contributions under a salary reduction agreement to tax-sheltered annuities (sec. 403(b)). These contributions have been held by the Treasury Department to be taxable for FICA purposes (Revenue Ruling 65-208) even though they are exempt by regulation from income tax withholding.[5] If the 1965 revenue ruling were determined to be invalid, then employers and employees would be eligible for refunds for open years because taxable wages would be lower. In addition, wages for benefit computation purposes would be reduced, leading in some cases to reduction of social security benefits being paid to current beneficiaries and recoupment of a portion of benefits which have been paid in recent years on the basis of wage records which included the salary reduction contributions.

Explanation of Provision

In order to avoid the inferences which this provision could raise, the bill clarifies the effective date of the provision overriding the *Rowan* decision so that the provision applies for all purposes, other than the treatment of certain employer-provided meals and lodging, both to remuneration paid after March 4, 1983, and to remuneration paid on or before March 4, 1983, which the employer treated as wages when paid. For example, if an employer treated as wages, for FICA or FUTA taxes (or both), the amounts contributed during 1982 to an employee's tax-sheltered annuity pursuant to a salary reduction agreement, the FICA or FUTA taxes (as the case may be) paid by the employer and employee may not be refunded or credited. The committee intends no inference as to the treatment of amounts paid on or before March 4, 1983, which the employer did not treat as wages when paid.

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[5] The Social Security Amendments provide explicitly that contributions to tax-sheltered annuities under a salary reduction agreement are included in the wage base for social security and FUTA purposes, effective for remuneration paid after December 31, 1983 (December 31, 1984, for FUTA).

11. Exclusion from coverage of foreign agricultural workers under the Agricultural Act of 1949 (secs. 643(a)(7)(A) and 643(i)(3) of the bill and sec. 210(a)(1) of the Act and sec. 3121(b)(1) of the Code)

Present Law

Under present law, service performed by foreign agricultural workers under contracts entered into in accordance with title V of the Agricultural Act of 1949, as amended are excluded from coverage under the Social Security Act and taxation under the Internal Revenue Code.

Explanation of Provision

In light of the fact that the provision of the Agricultural Act which provides for such contracts expired on December 31, 1964, the bill strikes the references in the law to the Agricultural Act of 1949, as amended.

12. Gender-based distinction concerning the penalty for fraud (sec. 643(e)(2) of the bill and sec. 1107(b) of the Act)

Present Law

Under present law, any person who, with the intent of eliciting information about the birth, employment, wages or benefits of any individual, falsely represents that he is either that individual or the husband, wife, widow, widower, divorced wife, child or parent of that individual is subject to the penalty for fraud set out in the law. However, a person who falsely represents himself as a divorced husband is not subject to the penalty.

Explanation of Provision

While the Social Security Amendments of 1983 sought to eliminate all gender-based distinctions in the Social Security Act, this gender-based distinction was not eliminated by those amendments. In order to assure that the Social Security Act provides the same penalty for fraud regardless of sex, the bill provides that the penalty for fraud would also apply to an individual who falsely represents that he is the divorced husband of a worker or beneficiary.

13. Treatment of social security benefits in computing credit for the elderly and disabled (sec. 643(i)(1) of the bill and sec. 86(f) of the Code)

Present Law

The credit for the elderly and permanently and totally disabled is equal to 15 percent of a base amount, which is reduced by amounts received of certain types of income (sec. 37). One such type of income is amounts received as a pension or annuity or disability benefit which is paid under title II of the Social Security Act and excluded from gross income. The section of the Social Security Amendments of 1983 dealing with the taxation of Social Security benefits contains a provision stating that social security benefits are to be treated as a pension or annuity for the purposes of certain Code sections, not including the credit for the elderly and disabled (sec. 86(f)).

Explanation of Provision

In order to remove any ambiguity as to the treatment of social security benefits in computing the credit for the elderly and disabled, the bill adds this credit to the list of provisions for which social security benefits are to be treated as an amount received as a pension or annuity.

14. Peer review organizations (sec. 646(a) of the bill and sec. 1866 of the Act)

Present Law

The Social Security Amendments of 1983 required hospitals to enter into an agreement with a Utilization and Quality Control Peer Review Organization (also known as a Peer Review Organization or PRO) as a condition of payment under the medicare program. The costs of such review are reimbursed through the medicare trust fund. A full transition from the Professional Standards Review Organization (PSRO) program to the PRO program has not yet been made.

Explanation of Provision

The bill treats PSRO's in a manner similar to that applied to PRO's under the Social Security Amendments while the transition is being made from PSRO's to PRO's. Hospitals would be required to enter into an agreement with a PSRO (which was in existence on July 1, 1983) within 60 days after enactment of the bill as a condition of medicare payment. The costs of the review will be paid from the medicare trust fund.

15. Medicare prospective payment (sec. 646(b) of the bill and secs. 1866, 1878 and 1886 of the Act)

Present Law

The Social Security Amendments of 1983 established a new system of paying hospitals under medicare, known as the prospective payment system.

Explanation of Provision

The bill clarifies that the percentage of payment to be made under target reimbursement as opposed to diagnosis related group payments (i.e., the phase-in of the DRG payment system from a cost-based system) is based on a hospital's cost reporting period, and that the 'applicable combined adjusted DRG prospective payment rates' are based on discharges occurring on or after October 1 of each year.

It was the intent of the legislation when passed that the DRG payment levels would change once a year, on October 1, with the Federal fiscal year. The blend of the regional and national payments into the DRG payment levels is a part of this calculation, and it was intended to be done once a year, beginning with the Federal fiscal year. This will mean that some hospitals, which have an accounting year beginning on a date other than October 1, will have less than a full hospital accounting year of a fully regional DRG payment.

To do otherwise would require that each medicare intermedicary keep a separate set of DRG payment levels for each hospital in an area depending on each hospital's accounting year. This would place a enormous administrative burden on the medicare program. Further, hospitals in the same area would have a different DRG payment level for the same service depending on the date on which the hospital's accounting year began.

The bill requires that State hospital cost control systems must prevent gaming and 'unbundling' of services and inappropriate admissions practices in order to be provided a medicare waiver.

The bill clarifies that public comment is required only on proposed determinations issued with respect to annual indexing of DRG's on June 1 of each year, beginning with fiscal year 1986.

The bill also requires that hospitals exempt from the DRG payment system have agreements with PRO's or PSRO's; it amends section 1878 of the Social Security Act to provide for consolidated judicial review of Provider Reimbursement Review Board (PRRB) determination of group petitions effective with respect to actions or appeals brought on or after the date of enactment of the bill; and it corrects a reference error in section 1818(c) of the Act.

16. Normalizing credit of medicare taxes to the Hospital Insurance Trust Fund (sec. 646(c) of the bill and sec. 1817 of the Act)

Present Law

The Social Security Amendments of 1983 revised the accounting procedures of the Old Age and Survivors, Disability, and Hospital Insurance Trust Funds to provide that the Treasury would credit to the trust funds, at the beginning of each month, the amount of payroll taxes estimated to be received during the month. Under prior law, amounts were paid to the trust fund from "time to time."

Explanation of Provision

The bill repeals the "normalization" provisions with respect to the Hospital Insurance Trust Fund. Thus, funds will be transferred from the Treasury to the HI Trust Fund as under prior law. The provision does not affect the OASDI Trust Funds.

17. Effective dates relating to certain medicare changes (sec. 646(d) of the bill and secs. 1878 and 1886 of the Act)

Present Law

The Social Security Amendments of 1983 made certain changes with respect to group appeals under the Provider Reimbursement Review Board. In addition, the Amendments required the Secretary of Health and Human Services to issue regulations with respect to prospective payment by a certain date.

Explanation of Provision

The bill clarifies that the PRRB changes only apply to appeals and actions brought on or after the date of enactment of the bill. The bill applies an implementation schedule for the State waiver provisions of prospective payment (sec. 1886(c)) requiring the publication of proposed regulations by May 1, 1984, followed by a 45-day comment period, and requiring publication of the final regulations by August 1, 1984.

18. Enrollment and premium penalty with respect to working aged provision (sec. 647 of the bill and sec. 1839 of the Act)

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 requires employers to offer to their employees age 65 through 69 the same group health plan which is offered to their employees under 65. Where the employee chooses the employer plan, medicare becomes the secondary payor.

Under present law, a penalty equal to 10 percent of the part B premium is assessed against an individual for every year in which he or she fails to enroll in medicare part B after he or she becomes eligible for benefits. Further, an individual who does not enroll when initially eligible at 65, may enroll in medicare only during the January through March enrollment period.

Explanation of Provision

The bill eliminates any penalty for late enrollment in medicare for any individual 65 through 69 for any month in which the individual can demonstrate that he or she was enrolled as an employee (or a spouse of an employee) in an employer group health plan which is a primary payor to the medicare program.

The provision is intended to apply with respect to months in which the individual was an employee and enrolled in a plan. Thus, an individual who was employed after age 65, became unemployed and was subsequently reemployed could count those periods during which he or she was employed and covered by a plan regardless of the intervening unemployment. The use of the phrase—by reason of current employment—was meant to distinguish those persons who are receiving health benefits based on employment and are actually employed from those persons who are receiving benefits based on employment, but who are now retired.

A special enrollment period will be provided to individuals age 65 through 69 who did not elect coverage under medicare during their initial enrollment period because of coverage at the time under an employer plan and who lose such employer coverage or turn 70 years of age. In addition, there is also a special enrollment period for those who were enrolled during periods in which they were not covered under an employer plan, who have not terminated medicare enrollment other than at a time when they were covered under such a group health plan or turn 70. These special enrollment periods begin either three months before the month in which the individual turns 70 and last seven months, or begin with the month in which the individual loses coverage under the employer plan and last seven months, whichever begins earlier. Where the individual has such a special enrollment period, because the individual turns 70 or the employer coverage terminates, medicare coverage begins in a manner similar to current law for individuals turning 65. If the individual enrolls in the month in which he or she turns 70, the coverage period begins with the first day of the following month.

The regulations issued by the Equal Employment Opportunity Commission pursuant to the original 'working aged' provision made it clear that employees were to be fully informed of their options at the time of selecting either the employer plan or medicare. One of the points which should be made clear to the beneficiary at the time he or she is informed of the options is the impact on the premium and on enrollment periods of certain decisions with respect to the employer plan and medicare.

The provision is effective with respect to months beginning with January 1983 for premiums for months beginning with July 1984. The special enrollment provisions are effective beginning July 1984.

19. Clerical amendments

The bill makes certain corrections of spelling, punctuation, cross-references and other clerical amendments to the Social Security Act and related provisions in the Internal Revenue Code.

F. Effective Dates

Except as otherwise described, the amendments made by the Technical Corrections Act of 1983 will take effect as if included in the original legislation to which each amendment relates.

G. Revenue Effect

The provisions contained in the Technical Corrections Act of 1983 have a negligible revenue effect.

TITLE VII—TAX-EXEMPT BOND PROVISIONS

A. Mortgage Subsidy Bonds

(Secs. 711-712 of the bill and sec. 103A and new secs. 25 and 6706 of the Code)

Present Law

Overview

The Mortgage Subsidy Bond Tax Act of 1980 (the "1980 Act")[1] imposed restrictions on the ability of State or local governments to issue bonds, the interest on which is tax-exempt, for the purpose of making mortgage loans on single-family, owner-occupied residences. The 1980 Act provided that interest on mortgage subsidy bonds is exempt from taxation only if the bonds are "qualified veterans' mortgage bonds" or "qualified mortgage bonds". The ability of State and local governments to issue tax-exempt qualified mortgage bonds expired on December 31, 1983.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to finance mortgage loans to veterans. Unlike qualified mortgage bonds, the tax-exemption for veterans' bonds did not expire on December 31, 1983, and veterans' bonds are not subject to the volume, arbitrage, and most of the targeting rules applicable to qualified mortgage bonds.

Qualified mortgage bonds

Qualified mortgage bonds must satisfy numerous requirements, discussed below. Also, interest on these bonds is tax-exempt only if the bonds were issued before January 1, 1984.

Volume limitations

The 1980 Act restricted the aggregate annual volume of qualified mortgage bonds that a State, and local governments within the State, can issue. The State ceiling is equal to the greater of (1) 9 percent of the average annual aggregate principal amount of mortgages executed during the 3 preceding years for single-family, owner-occupied residences located within the State, or (2) $200 million. The State ceiling is generally allocated 50 percent to State and 50 percent to local issuers (on the basis of mortgage activity), unless the State provides a different allocation formula.

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[1] Title XI of the Omnibus Reconciliation Act of 1980 (P.L. 96-499). The provisions adopted by the 1980 Act (Code sec. 103A) were subsequently amended by section 220 of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) (TEFRA).

Limitation to single-family, owner-occupied residences

All lendable proceeds (i.e., total proceeds less issuance costs and reasonably required reserves) of qualified mortgage bonds must be used to finance the purchase of single-family residences located within the jurisdiction of the issuing authority. Additionally, it must be reasonably expected that each residence will become the principal residence of the mortgagor within a reasonable time after the financing is provided. Generally, the term single-family residence includes 2-, 3-, and 4-family residences if (1) the units in the residence were first occupied at least 5 years before the mortgage is executed and (2) one unit in the residence is occupied by the owner of the units.

General limitation to new mortgages

With certain exceptions, all lendable proceeds of qualified mortgage bonds must be used for acquisition of new mortgages rather than existing mortgages. The exceptions permit replacement of construction period loans and other temporary initial financing, and certain rehabilitation loans. Rehabilitation loans must be made for work begun at least 20 years after the residence is first used and the expenditures must equal 25 percent or more of the mortgagor's adjusted basis in the building. Additionally, at least 75 percent of the existing external walls of the building must be retained as such after the rehabilitation.

Certain mortgage assumptions permitted

Loans financed by qualified mortgage bond proceeds may be assumed if the residence satisfies the location and principal residence requirements, discussed above, and the assuming mortgagor satisfies the 3-year and purchase price requirements, discussed below.

Limitation on advance refunding

Qualified mortgage bonds may not be advance refunded.

Targeting requirement

At least 20 percent of the lendable proceeds of each issue of qualified mortgage bonds (but not more than 40 percent of the average mortgage activity in the targeted area) must be made available for owner-financing in targeted areas for a period of at least one year. The term "targeted area" means a census tract in which 70 percent or more of the families have income which is 80 percent or less of the state-wide median family income, or an area designated as an area of chronic economic distress.

Three-year requirement

In order for an issue to be a qualified mortgage bond issue, at least 90 percent of the lendable proceeds must be used to finance residences for mortgagors who had no present ownership interest in a principal residence at any time during the 3-year period ending on the date the mortgage is granted.[2] The 3-year requirement does not apply with respect to mortgagors of residences in three situations: (1) mortgagors of residences that are located in targeted areas; (2) mortgagors who receive qualified home improvement loans;[3] and (3) mortgagors who receive qualified rehabilitation loans.

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[2] TEFRA reduced the percentage of bond proceeds that must be used in a manner satisfying the 3-year requirement from 100 percent to 90 percent, effective for bonds issued after September 3, 1982.

Purchase price restrictions

In order for an issue to be a qualified mortgage issue, all of the mortgages (or other financing) provided from the bond proceeds, except qualified home improvement loans, are required to be for the purchase of residences the acquisition cost of which does not exceed 110 percent (120 percent in targeted areas) of the average area purchase price applicable to that residence.[4]

Arbitrage requirements

In order for an issue to be a qualified mortgage issue, the issue is required to meet certain limitations regarding arbitrage as to both mortgage loans and nonmortgage investments.

Mortgage investments.—The effective rate of interest on mortgages provided under an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points.[5] This determination is made on a composite basis for all mortgages under the issue. Consequently, the effective interest rate on some mortgages may be greater than 1.125 percentage points above the yield of the issue if other mortgages have a lower effective interest rate.

Nonmortgage investments.—The 1980 Act also imposed restrictions on the arbitrage permitted to be earned on nonmortgage investments. The amount of qualified mortgage bond proceeds that can be invested at unrestricted yield in nonmortgage investments is limited to 150 percent of the debt service on the issue for the year. Exceptions to the 150-percent of debt service rule are provided for proceeds invested for an initial temporary period until such proceeds are needed for mortgages and for temporary debt service funds. Arbitrage earned by the issuer or an intermediary on nonmortgage investments must be paid or credited to the mortgagors or paid to the Federal Government.

Issuers of qualified mortgage bonds usually have established a reserve to secure payment of the debt service on the bonds. This reserve must be reduced as debt service is reduced. However, if the sale of any investment would result in a loss exceeding the amount otherwise required to be paid or credited to mortgagors, the investment may be retained until it can be sold without resulting in such a loss.[6]

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[3] Qualified home improvement loans are loans, not exceeding $15,000, that finance the alteration or repair of a residence in a manner that substantially protects "the basic livability or energy efficiency of the property" (sec. 103A(l)(6)).

[4] TEFRA increased the maximum purchase price restriction from 90 percent (110 percent in targeted areas) to its present level, effective for bonds issued after September 3, 1982.

[5] TEFRA increased the maximum permitted arbitrage from 1 percentage point to 1.125 percentage points, effective for bonds issued after September 3, 1982.

[6] The rule permitting retention of an investment where its disposition would result in a loss was added by TEFRA, effective for bonds issued after September 3, 1982.

Limited equity cooperatives

Present law provides that the owners of shares in housing cooperatives are to be treated as homeowners for purposes of the Code by allowing a deduction for the portion of the rents paid to the cooperative that are allocable to the interest and taxes paid by the cooperative on the property (sec. 216). The Tax Equity and Fiscal Responsibility Act of 1983, P.L. 97-248 (TEFRA) included changes in the mortgage subsidy bond provisions designed to enable tenant shareholders of cooperatives to be eligible for tax-exempt financing as owners of single family residences.

Reasons for Change

The committee believes that mortgage subsidy bonds can perform a valuable function by enabling first-time homebuyers who might otherwise be unable to purchase a home, because of high interest rates, to do so. When Congress, in 1982, decided to relax certain of the restrictions on mortgage subsidy bonds, the interest rate on taxable mortgages approached 15 percent and the housing market was in a state of extreme crisis. Since that time, there has been a significant improvement in the housing market; however, the average mortgage interest rate is approximately 13 percent, and it remains difficult for average Americans (particularly first-time homebuyers) to purchase a single-family residence. In this situation, the committee believes that the qualified mortgage bond program can continue to make an important contribution by making housing more affordable to low- and middle-income Americans. Accordingly, the committee decided that the qualified mortgage bond program should be extended.

In order to provide an opportunity for reassessment of the qualified mortgage bond program under changing conditions, the committee decided that the program should be extended for a 5-year period only (i.e., for bonds issued prior to January 1, 1989). In the interim, in order to ensure an adequate basis for reevaluation, qualified mortgage bonds will be subject to reporting rules similar to the TEFRA information reporting requirements for private purpose tax-exempt bonds.

While approving the extension of the qualified mortgage bond program, the committee is aware of the relative inefficiency of tax-exempt bonds as a means of providing a subsidy to first-time homebuyers. Additionally, the committee is aware that, because of the nature of tax-exempt financing, it may be difficult to target the subsidy provided by mortgage bonds to those most in need of housing assistance. The committee therefore decided to offer States and localities the alternative of distributing mortgage credit certificates (MCCs) in place of qualified mortgage bonds. The rules for distributing MCCs have been designed to provide assistance to the same beneficiaries eligible for qualified mortgage bonds at a subsidy level that is the same as or slightly greater than that provided by mortgage bonds. However, under the MCC program, the entire amount of subsidy flows directly to the first-time homebuyer, rather than part of the subsidy flowing to the first-time homebuyer and part to the tax-exempt investor and middlemen as under a bond program. Thus, the committee believes that MCCs will provide a larger subsidy at an equivalent, or reduced, revenue cost. Additionally, by varying the amount of individual credits, State and local issuing authorities may achieve greater flexibility in targeting the subsidy to those individuals who are considered most in need.

The committee intends that States and localities have the choice of issuing qualified mortgage bonds, MCCs, or any mixture of bonds and credits, according to their particular needs. However, because of the relative ease of issuing credits, the committee believes that a transitional rule is necessary to provide equity between States and to mimimize the potential revenue loss associated with MCCs. The committee therefore decided to impose a 5-year phase-in of authority to issue MCCs for States which issued less than their statutory maximum of qualified mortgage bonds in 1983. Also to mimimize the potential revenue loss, the committee decided that the minimum $200 million State ceiling for qualified mortgage bonds should not apply in determining the amount of MCCs which may be issued within a State. This rule is necessary to prevent States or localities from exchanging bond authority which may now be unusable (because the $200 million ceiling approaches or exceeds the volume of mortgage originations in the State) for authority to issue mortgage credits. In order to provide an opportunity to review the MCC program, the committee provided that authority to issue MCCs, together with authority to issue mortgage bonds, would sunset on December 31, 1988.

In deciding to extend the qualified mortgage bond program, the committee is concerned by the increasing volume of veterans' mortgage bonds being issued by a number of States (approximately $2.9 billion in the years 1980 through 1982) and the potential for expansion of veterans' mortgage bonds in States that do not issue those bonds. To limit the potential revenue loss from veterans' bonds, the committee decided that the amount of qualified mortgage bond authority for a State in any year should be reduced by the volume of veterans' mortgage bonds issued in the prior year. Additionally, the committee bill subjects veterans' mortgage bonds to the sunset applicable to qualified mortgage bonds. These changes are further intended to provide greater equity between States which emphasize a veterans' bond program and those which rely primarily on qualified mortgage bonds or credits.

The committee understands that housing cooperatives may have difficulties complying with the requirements for mortgage subsidy bond financing, in particular the first-time home buyer limitation. The committee believes that certain limited equity housing cooperatives have the same essential characteristics as multifamily residential rental projects and should therefore be eligible for tax-exempt financing under the industrial development bond provisions applicable to such projects. However, the committee believes that, where cooperatives are treated as multifamily residential rental property under the IDB provisions, such treatment should be consistent for all purposes of the Code. Consequently, the committee's bill provides that tenant stockholders of limited equity cooperative housing corporations which qualify for tax-exempt IDB financing as multifamily residential rental projects are not eligible for the deductions available to owners of single-family residences.

Explanation of Provisions

1. Extension of authority to issue qualified mortgage bonds

Qualified mortgage bonds

The bill extends the tax-exemption for interest on qualified mortgage bonds to bonds issued prior to January 1, 1989.

Qualified veterans' mortgage bonds

Under the bill, the tax-exemption for interest on qualified veterans' mortgage bonds is limited to bonds issued prior to January 1, 1989. Additionally, the State ceiling for qualified mortgage bonds is to be reduced by the aggregate amount of qualified veterans' mortgage bonds issued in the State during the preceding calendar year. For purposes of this reduction, a specified amount of qualified veterans' mortgage bonds the issuance of which was authorized by a State referendum before October 18, 1983, or the issuance of which was authorized pursuant to a State referendum before December 31, 1983, which referendum was authorized by action of a State legislature before October 18, 1983, are not to be taken into account. Except for this exception, the reduction in the ceiling for qualified mortgage bonds on account of qualified veterans' mortgage bonds issued in a prior year would begin in 1985 with respect to bonds issued in 1984.

Information reporting requirements

The bill requires that any issuer of mortgage subsidy bonds (including qualified mortgage bonds and qualified veterans' mortgage bonds) must submit to the Treasury Department, by the fifteenth day of the second calendar month after the close of the calendar quarter in which the bonds were issued, a statement providing certain information concerning the issue. This statement must contain (1) the name and address of the issuer, (2) the date of the issue, the amount of lendable proceeds of the issue, and the rate, term and face amount of each obligation which is part of the issue, and (3) such other information as the Treasury may require (including information required in order to determine whether the issue qualified for tax exemption). The bill allows the Treasury to provide for extensions of time for providing any information where there is reasonable cause for delay.

State allocation formulas

The bill provides that, if a State law which provides a formula for allocation of the State's qualified mortgage bond ceiling among State and local issuers expires as of the close of calendar year 1983, the law shall be treated as remaining in effect after 1983. If the expiring formula requires action by a State official in order to allocate the State ceiling, actions of such officials shall continue to be effective. The extension of the previously existing formula shall be effective until the effective date of any new State legislation with respect to allocation of the ceiling.

The bill further provides that a State's qualified mortgage bond authority is to be allocated, beginning 1985, 50 percent to local issuers on the basis of population (rather than mortgage activity as under present law), unless the State provides a different allocation formula.

2. Mortgage credit certificates

In general

The bill allows State and local governments to elect, for any calendar year beginning after 1983, to exchange all or part of their qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs entitle taxpayers to nonrefundable Federal income tax credits for not more than 50 percent (but not less than 10 percent) of interest on indebtedness incurred to finance the acquisition (or qualified rehabilitation or improvement) of qualifing principal residences. The credits are subject to the existing eligibility requirements for qualified mortgage bonds. For States and localities which issued less than their statutory maximum of qualified mortgage bonds during calendar year 1983, authority to issue MCCs is to be phased in over a 5-year period.

Mortgage credit certificates (MCCs)

Mortgage credit certificates (MCCs) are to take the form of certificates issued to qualifying homebuyers. Each certificate is to specify (1) the principal amount of indebtedness which qualifies for the credit and (2) the applicable percentage rate of the credit. The applicable percentage may not exceed 50 percent (25 percent in the case of mortgage assumptions), but may not be less than 10 percent, of interest on the qualifying indebtedness. (The actual amount of the credit in any year depends upon the mortgage interest paid during the taxable year.) The certificate entitles the taxpayer to a credit against his Federal income taxes for the applicable percentage of mortgage interest paid during any taxable year during which the taxpayer uses the residence as his principal residence.

MCCs are not refundable to the taxpayer (i.e., credit amounts in excess of any Federal income taxes will not be refunded to the taxpayer). However, excess credits can be carried over to reduce tax liability of the taxpayer arising in any subsequent year.

When a taxpayer receives an MCC, the taxpayer's deduction for interest on the qualifying mortgage (sec. 163(a)) is reduced by the amount of the credit. For example, a taxpayer receiving a 50-percent credit, and making $5,000 of interest payments on qualified indebtedness in a given year, is to receive a $2,500 credit and a deduction for the remaining $2,500 of interest payments.

Under the bill, MCCs are not available for residences financed with qualified mortgage bonds. Additionally, loans between related parties do not qualify for the credit. Finally, MCCs are not available if the homebuyer is required to obtain his mortgage from specified mortgagees.

Criteria for eligibility

MCCs generally are subject to the existing eligibility requirements applicable to qualified mortgage bonds. Thus, MCCs are generally (1) limited to single-family owner-occupied residences (as defined under the qualified mortgage bond provisions) located within the jurisdiction of the issuing authority, (2) available only for new mortgages (with allowances for qualified rehabilitation and improvement loans and for certain mortgage assumptions), and (3) available to finance the acquisition of residences the acquisition cost of which does not exceed 110 percent (120 percent in targeted areas) of the average area purchase price applicable to the residence. Additionally, 90 percent of MCCs must be distributed under each MCC program only to mortgagors who did not have a present ownership interest in a principal residence at any time during the 3-year period ending on the date the mortgage is granted (with exceptions for qualified rehabilitation and home improvement loans and residences located in targeted areas). Unless an issuing authority submits a plan to the Secretary of the Treasury for administering the 90 percent requirement and the Secretary is satisfied that such requirement will be met under the plan, 100 percent of the credits must be distributed to individuals who meet the 3-year requirement. At least 20 percent of the aggregate amount of MCCs issued under each program are required to be made available for financing in targeted areas for a period of at least one year. Finally, where MCCs are issued to finance a particular development, the developer is required to certify that the price for any residence is not higher than it would be without the use of the credits.

Under the bill, MCCs may be issued for debt incurred to refinance a principal residence if the refinancing takes the place of an existing mortgage for which a certificate has already been issued and does not extend the term or increase the principal amount of the original mortgage.

As in the case of qualified mortgage bonds, a State or locality may establish more stringent criteria for participation in an MCC program, including more stringent rules to prevent assumption of the credits.

Volume limitations

General limits.—Under the bill, the aggregate annual amount of MCCs distributable by a State or locality may not exceed 15 percent of the volume of qualified mortgage bond authority exchanged by the State or locality. For example, a State which is entitled to issue $200 million of qualified mortgage bonds, and which elects to surrender $100 million of bond authority, may distribute an aggregate amount of MCCs not exceeding $15 million.

The aggregate annual amount of MCCs issued by a State or locality is to be determined by multiplying (1) the principal amount of each MCC certificate issued by the State or locality by (2) the applicable percentage for each certificate, and adding the products. For example, a State with $15 million of MCC authority may distribute credits for 15 percent of the interest payments on mortgages having an aggregate principal amount of $100 million (thereby approximating the benefits provided by $100 million of mortgage subsidy bonds). However, the State also may issue any other mix of higher or lower percentage credits in an aggregate amount not exceeding $15 million (subject to the 10 -and 50-percent requirements and the targeting and purchase price requirements applicable to mortgage subsidy bonds). For example, a State may determine to issue higher percentage credits to lower-income individuals.

Where a State MCC program issues credits exceeding 15 percent of the amount of exchanged bond authority, the State's ceiling for the subsequent year is reduced by twice the excess.[7] Similarly, where a State MCC program failed to satisfy the proper eligibility requirements, the State's ceiling for the subsequent year is reduced by twice the amount of ineligible indebtedness.

Phase-in of and limitations on MCC authority.—States or localities which issued qualified mortgage bonds in amounts less than their maximum legal authority during calendar year 1983 are subject to a 5-year phase-in of authority to issue MCCs. For each of these years, the amount of qualified mortgage bond authority which a State or locality may exchange for authority to issue MCCs is limited to the volume of qualified mortgage bonds it actually issued in 1983, increased for each year by 25 percent of the remaining difference between the 1983 volume and the statutory amount. These amounts would be applicable regardless of the volume of bonds issued in any intervening year.

For example, a State which had authority to issue $200 million of qualified mortgage bonds in 1983, but actually issued only $100 million, would be entitled to exchange $125 million of authority in 1984 ($100 million plus 25 percent of the remaining statutory authority), $144 million in 1985 ($125 million plus 25 percent of authority remaining in 1984), $158 million in 1986, $167 million in 1987, and $175 million in 1988.

Where a State or locality issues both qualified mortgage bonds and MCCs, the phase-in will apply to the total amount of bonds and credits which it could issue. Thus, in the example above, the State, if it elected to issue MCCs, could use or exchange a total of $144 million of qualified mortgage bond authority in 1985. The phase-in does not apply if the State elects to issue only mortgage bonds.

Under the bill, the volume of bond authority exchanged for authority to issue MCCs may not exceed 9 percent of the average volume of mortgages on single family residences originated in the State in the prior three years. Thus, the $200 million safe harbor ceiling is not applicable for determining the maximum State volume of MCCs.

Public notification requirement

Under the bill, State or local housing agencies may issue MCCs only after making generally available, at least 90 days prior to distribution, a proposed plan of distribution of the credits. The proposed plan must set forth the eligibility requirements to receive MCC certificates, the methods by which the certificates would be issued, and such other information as the Treasury Department may require. State or local agencies may adopt plans of distribution for MCCs in connection with other housing assistance programs (including taxable bond issues, private development projects, or private mortgage lending programs).

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[7] It is expected that Treasury regulations will establish a procedure permitting the issuer (or other State or local agencies) to make binding certifications to the effect that an issue has not exceeded the issuer's volume limitation for the year of the issue. The regulations may provide Treasury with authority to suspend or withdraw such certifications if the certifications made by an issuer with respect to past issues are incorrect.

Administration of MCC program

The mortgage credit certificate program is to be administered as provided in Treasury regulations. It is anticipated that these regulations will provide that a local issuer desiring to issue mortgage credits will file an election with the housing authority (or agency designated by the Governor) for the State in which the issuer is located. The State housing authority will determine whether the issuer has sufficient qualified mortgage bond authority to cover the election and, if it does, the State housing authority will approve the election and notify the Internal Revenue Service of the election. The local issuer or State issuer will distribute MCCs to applicants who represent to the issuer in a signed statement that they meet the eligibility requirements pertaining to MCCs. The credit certificate will set forth relevant information such as the following: name of local issuer, the date of the local issuer's election to issue mortgage credit certificates, the name and social security number of the applicant, the percentage rate of credit, the maximum amount of the loan (if the State decides to impose a limit), and other relevant information required by the Treasury.

It is anticipated that the homebuyer to whom credit certificates have been awarded will take the credit certificate to a lending institution. The lending institution then will determine whether the applicant meets the first-time homebuyer requirement (by examining the applicant's tax returns) and the purchase price limit. The lending institution must sign a statement on the credit certificate, under penalties of perjury, that it has made the foregoing determinations and examined the applicant's tax returns. The institution also must state on the credit certificate the principal amount of the mortgage, the purchase price of the house, and the address of the property. The lending institution must send copies of the credit certificate to the homebuyer, the local issuer, and the State housing authority. The lending institution also must file reports with the IRS which permit the IRS to audit individual tax returns and to audit States to determine whether volume limits and other statutory requirements were satisfied. A penalty of $200 is imposed by the bill on a mortgage originator (i.e., lending institution) for failure to file the required information with respect to any homebuyer that received a credit certificate. Similar requirements are imposed on mortgage originators and their transferees with respect to homebuyers who assume a seller's mortgage together with a mortgage credit certificate.

It is anticipated that the Treasury regulations will require State housing authorities to file a report with the IRS for each calendar year showing the issuers qualified mortgage bond allocation, the dates and amounts of election to issue MCCs, and the total amount of credits issued pursuant to each election. The State housing authority will also be required to report if an existing credit certificate was revoked.

3. Limited equity cooperatives

The bill provides that limited equity housing cooperatives are eligible, at the election of the cooperative, for tax-exempt financing as multifamily residental rental housing (under sec. 103(b)(4)(A)). Limited equity housing cooperatives are cooperative housing corporations (as defined under sec. 216(b)(1)) in which a person is entitled to occupy a dwelling unit by reason of ownership of stock in the cooperative. Additionally, to qualify for financing as multifamily residential rental property, (1) the cost of any stock in the cooperative must not exceed the amount paid for the stock by the original stockholder (as adjusted for cost-of-living increases), increased by amounts paid for improvements on the stockholder's house or apartment and certain other payments and contributions attributable to the stockholder, and (2) the assets of the cooperative in excess of the combined transfer values of outstanding stock in the cooperative (reduced by any liabilities) must be used only for public or charitable purposes or directly to benefit the cooperative and must not be used directly to benefit any stockholder.

The bill provides that, where a limited equity housing cooperative elects to be eligible for financing as multifamily residential rental property, the cooperative's tenant shareholders will not be entitled to a deduction for their ratable share of interest and taxes paid by the cooperative (sec. 216). Additionally, bonds issued to finance units in the cooperative will be counted toward the State's volume cap for qualified mortgage bonds, except to the extent that the financing had previously been counted towards the volume cap for private activity bonds. The election to be eligible for financing as multifamily residential rental property is to be irrevocable and is to apply only if the cooperative continues to qualify as a limited equity cooperative.

If an election as described above is not made, a limited equity housing cooperative is eligible for qualified mortgage bond financing (as under present law). Such financing will be subject to all the limitations applicable to qualified mortgage bonds (including the first-time purchaser, purchase price, and statewide volume limitations).

Effective Date

The extension of the qualified mortgage bond program is effective on the date of enactment for bonds issued after December 31, 1983. The election for States and localities to issue mortgage credits is effective for interest paid or accrued after December 31, 1983, on mortgages executed after December 31, 1983, with respect to elections to trade in qualified mortgage bond authority of States and localities for calendar years after 1983.

The election of certain limited equity housing cooperatives to be treated as multifamily residental rental projects is effective for obligations issued after December 31, 1983.

The allocation of 50 percent of the State qualified mortgage bond authority among local issuers on the basis of population (unless the State provides a different formula for allocation) is effective for obligations issued after December 31, 1984.

Revenue Effect

This provision is estimated to reduce fiscal year receipts by $61 million in 1984, $248 million in 1985, $521 million in 1986, and $815 million in 1987.

B. Private Activity Bonds

(Secs. 721–726 of the bill and secs. 103 and 168 of the Code)

Present Law

Tax-exemption for State and local obligations

Interest on State and local government obligations generally is exempt from Federal income tax. Under this rule, State and local governments generally may issue tax-exempt bonds to finance public projects or services (including schools, roads, water, sewer, and general improvement projects and the financing of public debt). Additionally, State and local governments may provide tax-exempt financing for certain private trades or businesses, for student loans and for use by tax-exempt religious, charitable, scientific, or educational organizations.

Industrial development bonds

Under present law, industrial development bonds (IDBs) are taxable except when issued for certain specified purposes. Industrial development bonds are obligations issued as part of an issue all or a major portion of which are to be used in any trade or business carried on by a nonexempt person and the payment of principal or interest on which is derived from, or secured by, money or property used in a trade or business. A non-exempt person is defined to mean all persons other than State or local governments or tax-exempt charitable, religious, educational, etc. organizations (described in Code sec. 501(c)(3)).

Exempt purpose IDBs

One of the exceptions under which interest on IDBs is tax-exempt is where the proceeds of the IDBs are used for certain exempt functions. Under this rule, interest on IDBs is tax-exempt if the bonds are used to finance the following activities: (1) certain projects for mutlifamily residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities, or parking facilities; (5) sewage and solid waste disposal facilities, or facilities for the local furnishing of electricity or gas; (6) air or water pollution control facilities; (7) certain facilities for the furnishing of water; (8) qualified hydroelectric generating facilities; (9) qualified mass commuting vehicles; or (10) local district heating or cooling facilities. In addition, interest on IDBs used to acquire or develop land as the site for an industrial park is exempt from tax.

Treasury regulations provide that whether the proceeds of an obligation are used for exempt facilities is to be determined by the ultimate use of the proceeds. Treas. Reg. sec. 1.103-8(a)(4). The regulations illustrate this principle by indicating that bond proceeds are used for an exempt purpose where the proceeds of the bond are loaned to banks or other financial institutions who then relend those proceeds for exempt functions (referred to as a "loan to lenders" program).

Small issue IDBs

In general.—Present law provides a tax-exemption for interest on small issue IDBs used for the acquisition, construction, or improvement of land or depreciable property referred to as "the small-issue exception". [8] This exception applies to issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of related capital expenditures during the 6-year period beginning 3 years before the date of issue and ending 3 years after that date, must not exceed $10 million.[9]

In determining whether an issue meets the requirements above, prior small issues and (in the case of the $10 million limitation, capital expenditures) are taken into account if (1) they are with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with small-issue IDBs, and (2) the principal users of both facilities are the same or two or more related persons. "Related persons" include family members, fiduciaries, and corporations (or partnerships) subject to common control. Capital expenditures are not taken into account if (1) they are made to replace property destroyed or damaged by fire, storm, or other casualty, (2) are required by a change in Federal, State or local law (or the application of such laws) made after the date of issue, (3) are required by circumstances which could not reasonably be foreseen on the date of issue, or (4) are qualifying in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

The Internal Revenue Service has generally ruled that, for purposes of the small issue volume limitations, where the facilities comprising a project are owned by unrelated parties, each party will be considered the principal user only of its own facility. Thus, under present law, a project in excess of $10 million (e.g., a multistory office building) may be divided into several nominally separate facilities, each costing $10 million or less, and each separate facility may be financed by corresponding separate small issues of IDBs.

Limitations on small issue IDBs.—The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, imposed the following new restrictions on small-issue IDBs. First, TEFRA provided that the small issue exception will not apply to obligations issued after December 31, 1986. Second, TEFRA provided that the $1 million "clean limit" exemption is not available for any IDB issued as part of the same issue as other obligations, the interest on which is tax-exempt under a provision other than the small-issue exception. (The alternative $10 million limitation remains available for combined issues.) Third, TEFRA eliminated the small-issue exception for bonds issued after December 31, 1982, if (1) more than 25 percent of the proceeds of the issue are used to provide a facility the primary purpose of which is retail food and beverage services (including all eating and drinking establishments but not grocery stores), automobile sales or service, or the provision of recreation or entertainment, or (2) any portion of the proceeds is used to provide any private or commercial golf course, country club, massage parlor, tennis club, skating facility (including roller skating, skateboard, and ice skating), racquet sports facility (including any handball or racqetball court), hot tub or sun tan facility, or racetrack. These use limitations do not affect bonds issued pursuant to exemptions other than the small-issue exception.

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[8] The small-issue exception does not apply to obligations a significant portion of the proceeds of which are used to provide residential rental property for family units.

[9] In the case of facilities with respect to which an Urban Development Action Grant ("UDAG grant") is made under the Housing and Community Development Act of 1974, capital expenditures of up to $20 million are allowed.

In addition to the above limitations, TEFRA provided that multiple lots of small-issue IDBs are not to be treated as one issue unless the proceeds are used to finance two or more facilities which (1) are located in more than one State or (2) have the same or related principal users.[10] Under this rule, multiple lots of IDBs may qualify as tax-exempt as long as each separate issue qualifies as a small issue.

Scholarship funding bonds

In addition to State and local obligations, qualified scholarship funding bonds are exempt from Federal income tax. Qualified scholarship funding bonds are obligations issued by a not-for-profit corporation established and operated exclusively for the purpose of acquiring student loan notes. To qualify for tax-exemption, the corporation must be required to use any income (after payment of expenses and debt service) to purchase additional student loan notes, or to pay over any income to the State or a political subdivision.

Cost recovery for property financed with tax-exempt bonds

Accelerated cost recovery (ACRS)

Present law provides for a reasonable depreciation allowance for property used in a taxpayer's trade or business or held for the production of income. Under the Economic Recovery Tax Act of 1981 (Pub. L. 97-34), cost recovery for tangible property placed in service on or after January 1, 1981, is determined according to the Accelerated Cost Recovery System (ACRS). ACRS provides for capital cost recovery over predetermined periods that are generally unrelated to, but shorter than, the useful lives of the property as determined under prior law.

Recovery of costs under ACRS is determined by using a statutorily accelerated method. The schedules approximate the benefits of using a 150-percent declining balance method for the early recovery years and the straight-line method for later recovery years. For 15-year real property, the schedule reflects a 175 percent declining balance method (200 percent for low-income real property) switching to the straight-line method.

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[10] For purposes of this rule, "principal users" include persons (other than governmental units) which (1) arrange or assist in the issuance or guarantee (directly or indirectly) the repayment of any obligation used to finance the facility, and (2) provide any property, franchise, or trademark to be used in connection with the facility.

As an alternative to ACRS, a taxpayer may elect to depreciate real or personal property using the straight-line method over ACRS or extended recovery periods.

Property financed with tax-exempt bonds

Property placed in service on or after January 1, 1983, generally is not eligible for full ACRS deductions or other accelerated cost recovery deductions, to the extent that the property is financed with tax-exempt IDBs. In lieu of the full ACRS deductions reflecting the accelerated recovery rates, the cost of personal property financed with IDBs must be recovered using the straight-line method (using a half-year convention and without regard to salvage value) over the applicable ACRS period. For 15-year real property, costs are to be recovered using the straight-line method (using a monthly convention and without regard to salvage value) over a 15-year period.

Present law contains several exceptions under which IDB-financed facilities may continue to be eligible for full ACRS deductions. The exceptions include: (1) projects for multifamily residential rental property; (2) public sewage or solid waste disposal facilities, where substantially all of the sewage or solid waste (other than recycled waste) processed by the facility is collected from the general public; (3) air or water pollution control facilities which are installed in connection with a facility in existence on July 1, 1982, or which are used in connection with conversion of oil- or gas-fired facilities to coal (but only if the oil- or gas-fired furnace which is converted to coal was in use at the facility before July 1, 1982); and (4) facilities with respect to which an Urban Development Action Grant ("UDAG grant") has been made.

The limitations on ACRS deductions, where applicable, apply to both the first owner of the property and to any subsequent owners who acquire the property while the tax-exempt IDBs (including any refunding issues) are outstanding.[11] The limitations do not apply if the taxpayer has elected a longer recovery period for the property than that provided by the limitations.

Arbitrage limitations

Present law denies tax-exemption for interest on obligations (including IDBs or other State or local obligations) which are treated as arbitrage bonds. An arbitrage bond is defined as an obligation which is part of an issue all or a major part of the proceeds of which are to be used (directly or indirectly) to acquire taxable obligations which produce a materially higher yield than the yield on the tax-exempt obligations (or to replace funds which are so used). There are exceptions for materially higher yielding obligations held for a temporary period or in a reasonably required reserve or replacement fund.

Present law does not provide a statutory definition of what constitutes a "materially higher" yield. However, Treasury regulations provide rules for purposes of determining when an obligation acquired with the proceeds of tax-exempt bonds has a yield materially higher than the bond yield. In general, a yield more than 0.125 percent above the bond yield is considered materially higher. In the case of certain obligations, such as student loans and loans to provide housing, the yield on the acquired obligations may exceed the bond yield by as much as 1.5 percent.

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[11] If tax-exempt IDBs are first issued after the property is placed in service, the taxpayer is required to recompute any cost recovery deductions claimed for the property in prior years.

Advance refundings

Under present law, advance refunding obligations generally do not qualify for tax-exemption. Advance refunding obligations include obligations issued to refund an IDB where the refunding issue is issued more than 180 days before the prior issue is redeemed. The Code provides a special exception under which advance refundings of IDBs issued to finance convention or trade show facilities or airports, docks, wharves, mass commuting facilities, or parking facilities (sec. 103b(4)(C) and (D)) qualify for tax-exemption if the facilities financed with the IDBs are generally available to the general public.

Federally guaranteed tax-exempt bonds

In general

The Public Debt Act of 1941 prohibits the Federal Government from issuing tax-exempt obligations. Since enactment of that Act, the Federal Government generally has refrained from guaranteeing tax-exempt State or municipal bonds. However, in the case of bonds the proceeds of which are deposited in Federally insured accounts or deposits in financial institutions, Federal deposit insurance may provide an effective quarantee for the bonds. In certain other cases, Federal agencies may provide additional security for tax-exempt bonds through (1) guaranteeing of obligations which are used to secure tax-exempt bonds or (2) subordinating debts owed to the Federal Government to the tax-exempt bonds. In other cases, regulations specifically prohibit the guarantee of tax-exempt obligations.

Tax-exempt IDBs guaranteed by FDIC or FSLIC

Federal deposit insurance laws.—The Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) insure deposits to a maximum of $100,000 per depositor.[12] Where assets of a trust are deposited in Federally insured institutions, the trust funds are insured up to $100,000 for each beneficial owner of the funds.[13] Additionally, where a public official deposits funds required to be paid to holders of bonds issued by a public unit, the interest of each bondholder is insured up to $100,000.[14]

The FDIC and FSLIC concluded in letter rulings issued in 1982 that, where the proceeds of a tax-exempt bond issue are used to purchase certificates of deposit of insured financial institutions, which may occur in a loan-to-lenders program, each bondholder's proportionate interest in the deposits would be separately recognized. Thus, if one or more depository banks failed, the interest of each bondholder would be insured up to $100,000 for each depository bank.

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[12] The FDIC provides insurance for deposits in commercial banks and State mutual savings banks. The FSLIC insures deposits in savings and loan associations, Federal mutual savings banks, and certain other thrift institutions.

[13] 12 U.S.C. sec. 1817(i) and 12 C.F.R. sec. 331(b) (FDIC); 12 U.S.C. sec. 1724(b) and 12 C.F.R. sec. 564.2(c) (FSLIC).

[14] 12 C.F.R. sec. 330.8(b) (FDIC); 12 C.F.R. sec. 564.8(b) (FSLIC).

Typical structure of FDIC- and FSLIC-insured bonds.—In certain issues of tax-exempt bonds, the issuing authority has deposited the bond proceeds in bank or savings and loan accounts insured by the FDIC or the FSLIC, to be loaned to the user by the depository institution. In the typical arrangement, the issuer transfers the proceeds to a trustee for the bondholders, which deposits the funds in FDIC- or FSLIC-insured certificates of deposit. The depository institution agrees to provide the deposited funds to private users for purposes eligible for tax-exempt IDB financing. Interest and principal on the bonds are repaid from payments on the certificates of deposit. The repayment of the bonds is secured by the certificates. Because the proceeds of the bonds are used ultimately for exempt purposes, the bonds qualify as tax-exempt under present law. Because the trustee for the bondholders holds a certificate of deposit in an insured institution, the amount of each bondholder's holdings is insured to the extent of $100,000.

Small Business Administration guarantees

The Small Business Administration (SBA) is authorized to guarantee 100 percent of the payments due from eligible small businesses under contracts for the planning, design or installation of governmentally mandated pollution control facilities.[15] The current policy of the SBA is to avoid participation in projects financed with tax-exempt obligations. However, the House Committee on Small Business has reported favorably[16] a bill (H.R. 3020) which would prohibit SBA from declining to participate in projects because of the presence of tax-exempt financing.

Department of Housing and Urban Development guarantees

Rental subsidies.—Section 11(b) of the Housing Act of 1937[17] provides a special tax-exemption for obligations issued by State and local housing agencies in connection with low-income housing projects. The Act prohibits the Department of Housing and Urban Development (HUD) from guaranteeing any tax-exempt obligation issued by a State or local agency.[18] However, under certain circumstances, an issuer may pledge HUD loans or contributions (which are backed by the full faith and credit of the United States) as security for tax-exempt obligations.

Mortgage insurance.—In addition to the above program, the Federal Housing Authority (FHA) is authorized to insure mortgages on various properties, including certain owner-occupied housing, rental and cooperative housing, housing for moderate income and displaced families, housing for elderly persons, and hospitals and nursing homes.[19] These mortgages insured by FHA may include mortgages on properties constructed with tax-exempt financing. In these situations, FHA-insured mortgages may be pledged as security for tax-exempt bond.

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[15] Small Business Investment Act of 1958, 15 U.S.C. sec. 694-1.

[16] H. Rep. No. 98-182, 98th Cong., 1st Sess. (May 16, 1983). The Senate Committee on Small Business has reported a similar bill.

[17] 42 U.S.C. sec. 1437i(b).

[18] 42 U.S.C. sec. 1437i(b).

Veterans' Administration guarantees

The Veterans' Administration (VA) is authorized to insure mortgages on various properties owned by veterans of the U.S. Armed Forces and their families. VA-insured mortgages may include mortgages on certain properties constructed with tax-exempt financing. In those cases, the VA-insured mortgages may be pledged as security for repayment of the tax-exempt bonds.

Student loan bond guarantees

The Department of Education guarantees repayment of various forms of student loans. In certain cases, Federally guaranteed student loans may be pledged as security for repayment of tax-exempt bonds.

Department of Agriculture (Farmers Home Administration) guarantees

The Farmers Home Administration (FmHA) guarantees loans for various agricutural purposes, including emergency loans, farm operating loans, farm ownership loans, soil and water loans, business and industrial loans, economic emergency loans, and guaranteed rural housing loans. The FmHA amended its regulations in 1982 to provide that FmHA will not guarantee loans made with the proceeds of tax-exempt obligations.[20] Additionally, no FmHA loan may serve as collateral for a tax-exempt issue.

Energy program guarantees

Under certain energy production or conservation programs, the Federal Government may guarantee the payment of principal or interest on IDBs used to finance qualified hydroelectric generating facilities or qualified steam-generating or alcohol-producing facilities. The Internal Revenue Code (sec. 103(h)) eliminates the tax-exemption for interest on bonds guaranteed under these programs. Additionally, the tax-exemption is eliminated when principal or interest on the bonds is to be paid with funds provided by the Federal government (or by State or local governments) under an energy production or conservation program.

Tax-exemptions outside the Internal Revenue Code

In addition to the tax-exemptions provided under the Internal Revenue Code, certain non-tax statutes provide an exemption for interest on specified obligations. Obligations to which these provisions apply generally are not subject to the restrictions on tax-exempt bonds contained in the Internal Revenue Code.

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[19] National Housing Act of 1934, 12 U.S.C. sec. 1707 et seq.
[20] 7 CFR sec. 1980.23.

District of Columbia Bonds

Under the District of Columbia Self-Government and Governmental Reorganization Act , Pub. L. 93-198, the District of Columbia is authorized to issue (1) general obligation bonds and (2) revenue bonds and notes for use in the areas of housing, health, transit and utility facilities, recreational facilities, college and university facilities, pollution control facilities, and industrial and commercial development. Under the Act, the obligations are exempt from all Federal and District taxation (except estate and gift taxes).[21]

The Internal Revenue Service has held that interest on bonds and notes issued by the District of Columbia is exempt from Federal income taxes notwithstanding the industrial development bond provisions of the Internal Revenue Code.[22] Thus, the District of Columbia may issue bonds for industrial and commercial development without regard to the limitations on small-issue IDBs. However, the bonds remain subject to an arbitrage limitation.

Possessions bonds (Puerto Rico, Virgin Islands, and Guam)

Under the Puerto Rico Federal Relations Act,[23] bonds issued by the Government of Puerto Rico, or by its authority, are exempt from Federal, State, and Puerto Rican taxation. Similarly, the government of the Virgin Islands may issue tax-exempt general obligations for public works, slum clearance, urban redevelopment or to provide low-rent housing. The government of Guam also has authority to issue obligations that are exempt from Federal, State or Guam taxation.[24]

Housing and Urban Development Bonds

Section 11(b) of the Housing Act of 1937[25] provides a special tax-exemption for certain obligations issued by State and local public housing agencies in connection with low-income housing projects. The exemption is limited to projects developed, acquired, or assisted by the State or local agency. The project units must generally be rented to families whose incomes do not exceed 80 percent of the median income for the area (as determined by the Department of Housing and Urban Development).

TEFRA restrictions on private activity bonds

In addition to providing limitations on small issue IDBs (including the December 31, 1986 sunset for small issue IDBs) and on cost recovery for IDB-financed property, TEFRA made several changes in the rules concerning IDBs generally. First, TEFRA required that issuers of all private activity bonds (including IDBs, scholarship funding bonds, and bonds issued by charitable organizations exempt from tax under sec. 501(c)(3)) to make quarterly information reports to the IRS concerning bonds issued by that issuer. TEFRA also required that issuance of IDBs be approved by an elected official in the issuing jurisdiction, and in all jurisdictions where the facilities financed with the bonds will be located, following a public hearing (or that issuance be approved pursuant to a voter referendum). In addition, the average length of time to maturity of IDBs generally was limited by TEFRA to 120 percent of the economic life of the property financed.

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[21] D.C. Code sec. 47-332.
[22] Rev. Rul. 76-202, 1976-1 C.B. 26.
[23] Laws 1917, ch. 145, 39 Stat. 953 (48 U.S.C. sec. 745).
[24] Pub. L. 418, 81st Cong., 1st Sess. (1949) (48 U.S.C. sec. 1403).
[25] 42 U.S.C. sec. 1437i(b).

Reasons for Change

General considerations

The committee is extremely concerned with the volume of tax-exempt bonds used to finance private activities. The volume of these bonds has increased sharply over the past few years—from $6.2 billion in 1976 to $44.0 billion in 1982. During this same period, private activity bonds increased from 21 percent of total State and local borrowings in 1975 to 51.7 percent in 1982. The TEFRA limitations on private activity bonds, including public notice and approval and information reporting requirements, limitations on cost recovery, and limitations on small issue IDBs, restricted the benefits associated with certain IDB-financed projects and eliminated some of the worst abuses associated with private activity bonds. However, the TEFRA rules appear unlikely to impose adequate limits on the overall growth in the volume of private activity bonds.

The rapid growth of private activity bonds is a source of concern for several reasons. First, the mounting volume of private activity tax-exempt bonds has resulted in an increasing revenue loss (a projected $8.5 billion for 1983 from identifiable private activity bonds). Because a substantial portion of the benefits of tax-exemption flows to the investor, tax-exempt bonds are a relatively inefficient means of providing a subsidy.

Second, the committee is concerned that the expanding volume of private activity bonds has inflated tax-exempt interest rates, thereby increasing the costs of State and local borrowing for traditional public purposes (schools, roads, public projects, etc). Competition from private activity bonds may thus force State and local governments to choose between raising taxes in order to meet increased borrowing costs or providing a lower level of services.

Finally, the availability of tax-exempt financing for certain types of projects tends to encourage investment in such projects independent of the economic value of the project. Such financing may therefore divert investment capital away from its most productive uses.

Volume ceilings for IDBs and student loan bonds

To prevent further unrestrained growth in private activity bonds, the committee believes that meaningful limitations should be imposed on the volume of private activity tax-exempt bonds. However, the committee continues to believe that the decision of what types of projects should be financed is best made by the appropriate State or local government. To achieve these goals, the committee decided to place a statewide ceiling, effective in 1984, on the overall volume of private activity bonds which may be issued. The ceiling, set initially at $150 for each resident of the State, will apply to certain industrial development bonds and student loan bonds issued within the State. (Qualified mortgage bonds have been subject to separate statewide volume limits since 1980 and the bill places qualified veterans' mortgage bonds within this volume cap.)

Within the statewide ceiling, and within the other rules applicable to private activity bonds, State and local governments will be free to issue bonds to finance activities which they determine serve the greatest public benefit. The committee therefore believes that the volume limits will impose meaningful limits on the growth of tax-exempt bonds without impinging unnecessarily on State and local perogatives. Further, the committee believes that the limits will result in tax-exempt financing being provided to those projects which best serve the public interest.

While desiring to limit the growth of private activity bonds, the committee is aware that the current definition of IDBs may encompass certain facilities which are traditionally thought of as public facilities and which perform essentially public functions. The committee is also aware that certain of these facilities are large, one-time projects which may be particularly difficult to finance under a volume ceiling. To prevent hardships of this sort, the bill exempts from the volume ceiling IDBs which are used to finance convention, trade show, and certain transportation facilities if no person other than a governmental unit owns the facilities being financed. In providing this exception, the committee believed it appropriate, because advance refundings duplicate amounts of bonds outstanding with respect to a facility, to repeal the existing provision which allows for advance refunding of bonds used to finance these and certain other related types of facilities.

The committee recognize the importance of tax-exempt bonds in financing multi-family housing for low- and moderate-income renters. Thus, bonds for this purpose are exempted from the volume ceiling and certain other restrictions in the bill. The committee also believes that private nonprofit organizations (sec. 501(c)(3)) should continue to benefit from tax-exempt financing without being forced to compete with private businesses. This is consistent with the general treatment of these organizations, which are exempt from Federal taxes and are (in most cases) entitled to receive tax-deductible contributions. Accordingly, the committee decided that bonds issued to provide financing for section 501(c)(3) organizations (other than with respect to proceeds used in an unrelated trade or business) should not be included in the statewide ceiling.

The committee believes that States which have issued bonds in excess of their statewide ceiling in 1983 should be allowed a reasonable period in which to adjust to the ceiling. The committee's bill therefore allows these States to phase down to the applicable limit so that all states are subject to the $150 cap beginning in 1985.

Further restrictions

In addition to the volume limits on private activity bonds, the committee believes that a number of other modifications to the rules applicable to tax-exempt financing need to be changed.

Federally guaranteed tax-exempt obligations

First, the committee is concerned by the combination of tax-exempt financing with Federal guarantees. This combination results in a double subsidy for certain activities. Since federally guaranteed tax-exempt bonds are more attractive than United States Treasury securities (which are taxable) and other State and local obligations (which do not have Federal guarantees), the proliferation of such bonds may make it difficult for both the Federal and State governments to raise needed funds. The committee's bill therefore eliminates the tax-exemption for interest on bonds where a substantial portion of the issue is to be guaranteed, directly or indirectly, by the Federal Government. This restriction applies to tax-exempt bonds the proceeds of which are deposited in Federally insured financial institutions, thereby receiving an effective guarantee. However, the committee decided that guarantees of bonds for certain housing-related guarantees, student loan guarantees and small business pollution control bond guarantees were necessary to the success of the related programs and should be exempted from the rule.

Limitations on cost recovery deductions

The committee believes that the general rule provided by TEFRA that the cost of IDB financed property should be recovered on the straight line method over ACRS lives is appropriate because the combined benefits of tax-exempt financing and full ACRS deductions provide an unnecessarily large subsidy. The committee concluded that most of the exceptions provided by TEFRA to that rule are unnecessary. Accordingly, the committee bill removes most of the TEFRA exceptions. However, the committee concluded that multifamily housing projects financed with tax-exempt bonds should continue to be eligible for accelerated cost recovery.

Miscellaneous changes

The committee bill also imposes other restrictions (in addition to those imposed by TEFRA) on IDBs. These restrictions are designed, in part, to prevent the aggregation of small issue bonds so as to provide extensive amounts of financing for one large-scale project. In addition, the bill tightens the arbitrage restrictions on certain tax-exempt IDBs and student loan bonds by extending the arbitrage rules similar to those applicable to mortgage subsidy bonds to all such bonds, limits the use of IDBs to acquire land and existing facilities, subjects bonds with respect to which tax-exemption presently is outside the Internal Revenue Code to Code provisions, and makes certain other changes in the law regarding private activity tax-exempt bonds.

Explanation of Provisions

1. Volume limitation on IDBs and student loan bonds

In general

The bill imposes a ceiling on the volume of tax-exempt industrial development bonds (IDBs) and student loan bonds that each State (including U.S. possessions) may issue during any calendar year. The ceiling does not apply to IDBs the proceeds of which are used to finance projects for multifamily residential rental property (sec. 103(b)(4)(A)) including any public housing program obligation issued under section 11(b) of the United States Housing Act of 1937. Additionally, the ceiling does not apply to IDBs to finance convention or trade show facilities or airports, docks, wharves, or mass commuting facilities (sec. 103(b)(4)(C) and (D)), but only if the property financed by the IDBs is owned by a governmental unit. For this purpose, publicly owned mass commuting vehicles which are associated with qualified mass commuting facilities are to be included in the definition of section 103(b)(4)(D) property. IDB-financed property will be considered to be owned by a governmental unit if no nongovernmental entity is considered an owner of the property for Federal income tax purposes and if no such entity is, therefore, entitled to cost recovery deductions or an investment tax credit for any portion of the property. Facilities may qualify for this exception even if the governmental unit's obligation to pay interest and principal on the bonds is limited to revenues from fees collected from users. This exception from the volume limitation does not apply to parking facilities financed with IDBs under section 103(b)(4)(D) of the Code. However, parking facilities which are functionally related and subordinate to a facility which qualifies under the exception (i.e., airport parking facilities) are included within the exception.

For purposes of the volume limitation, student loan bonds include any obligation which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly to finance loans to individuals for education expenses.

The volume ceiling does not apply to bonds which are neither IDBs nor student loan bonds (e.g., bonds issued to organizations described in section 501(c)(3) for use other than in unrelated trades or businesses and bonds used to finance traditional governmental activities).[25A]

Size of ceiling

The volume ceiling is $150 for every individual who is a resident of the State as determined by the most recent estimate of the State's population by the Bureau of the Census as of the beginning of the calendar year to which the limitation applies. The $150 ceiling will continue until 1987, when the ceiling will be reduced to $100 in order to reflect the termination in present law of the tax-exemption for small issue IDBs.

Phase-in of ceiling

For States whose annualized per capita issuance of IDBs and student loan bonds subject to the volume limitation during the first nine months of 1983 was more than $150, a special phase-in rule applies. Under the phase-in rule, the per capita amount that can be issued in such a State in 1984 is equal to $150 plus one-half of the difference between the 1983 per capita issuance level and $150.

[25A] The State of Texas has a program called the Texas Veterans' Bond Program under which general obligation bonds are issued for the purchase of land. Loans under this program are limited to $20,000 per veteran. Where the proceeds of such a bond issue, other than an amount which is not a major portion of the proceeds, are used, for example, for the acquisition of land for recreational or other non-trade or business purposes of its owners, the issue would not be subject to this limitation. The use of the proceeds by the veteran may be established by an affidavit of the veteran unless there is actual knowledge or reasonable information that would indicate a different usage.

Thus, by 1985, all States will be limited to the $150 per capita ceiling.

Allocation of ceiling among various governmental units

In general.—Under the bill, the State ceiling is allocated among the various governmental units within the State that can issue IDBs or student loan bonds pursuant to a three-step rule. This allocation is the same as that provided for mortgage subsidy bonds.

Under the first step, the State ceiling is allocated equally between the State (and its agencies) and localities until either the governor or the legislature makes a different allocation. The later allocation for a particular year would be reduced by bonds issued under the first allocation. One-half of the State ceiling is allocated to the State and its agencies that have authority issue IDBs or student loan bonds. The other one-half of the State ceiling is allocated to localities that have authority to issue IDBs or student loan bonds on the basis of the relative populations of those localities as determined by the most recent population estimate for the localities from the Bureau of the Census available before the beginning of the calendar year to which the ceiling relates. Where there are two overlapping local governmental units, a portion of the ceiling is allocated to the governmental unit with jurisdiction over the smallest geographical area. That portion is determined by multiplying the one-half of the State ceiling by a fraction, the numerator of which is the most recent population estimate of that governmental unit from the Bureau of the Census at the beginning of the calendar year to which the limit relates and the denominator of which is the population of the entire State using that same data. The remaining portion allocable to the governmental unit with jurisdiction over the larger area would be equal to one-half of the State ceiling multipied by a fraction the numerator of which is the population of the larger governmental unit not residing in the smaller governmental unit and the denominator of which is the population of the entire State.

Where two governmental units have authority to issue IDBs or student loan bonds and both governmental units have jurisdiction over the identical geographical area, the portion of the one-half of the State ceiling allocable to that area is allocated to the governmental unit having the broader sovereign powers. For example, where a city and an IDB authority for the city have authority to issue IDBs, then the portion of the one-half of the State ceiling allocable to the city based upon the population of that city is allocated to the city since the city has broader sovereign powers than the IDB authority.

Under the second step, the governor of the State is authorized to allocate the State ceiling among all of the governmental units (both State and local) having authority to issue IDBs or student loan bonds. This power of the governor to allocate the State ceiling terminates after the first day of the calendar year beginning after 1983 during which the legislature of the State met in regular session or the effective date of any State legislation with respect to the allocation of the State ceiling enacted after the date of enactment of this bill. If the legislature of any State has met and adjourned *sine die* before 60 days after enactment of the bill, however, the power of the governor terminates after the first day of the first calendar year beginning after the year in which the legislature next meets.

Under the third step, the State legislature may enact a law providing for a different allocation than that provided in step one. Under this authority, the State legislature may allocate all or any portion of the State ceiling to any governmental unit in the State that has authority to issue IDBs or student loan bonds.

Special rule for home rule subdivisions.—The bill provides a special allocation rule for certain political subdivisions with home rule powers. The home rule subdivisions to which the special allocation rule applies are those home rule subdivisions that are granted home rule powers by the beginning of the calendar year in which the bonds are issued pursuant to a State constitution that was adopted in 1970 and become effective on July 1, 1971 (Illinois). In that State, a full portion of the State ceiling is allocated to each home rule subdivision based upon the ratio that the population of that home rule subdivision bears to the population of the entire State, determined using the most recent population estimate from the Bureau of the Census which are available before the beginning of the calendar year to which the bonds relate using the same data for both the State and the home rule subdivisions. The amount so allocated to home rule subdivisions cannot be altered by the power to provide a different allocation which the bill grants to the governor or the State legislature described above. However, a home rule subdivision can agree to a different allocation.

The remaining portion of the State ceiling (i.e., the State limit reduced by the amount allocated to home rule subdivisions) is then allocated among the other governmental units in the State that have authority to issue IDBs or student loan bonds under essentially the same three steps described in the previous section. Thus, under the first step, one-half of the remaining State ceiling is allocated to the State and its agencies. The other one-half of the remaining State ceiling is allocated to the localities outside of the home rule subdivisions based upon the ratio that the populations of those localities outside of home rule subdivisions bears to the population of the State's residents located outside of home rule subdivisions. Under the second and third steps described above, the governor or the State legislature can allocate the State ceiling other than that allocated to home rule subdivisions to any governmental units that have authority to issue IDBs or student loan bonds (including home rule subdivisions), but they may not allocate the amount specially allocated to the home rule subdivisions.

Refunding issues

Under the bill, all IDBs (other than those for which exceptions are provided) and student loan bonds issued during the calendar year, other than certain refunding bonds, count towards the State ceiling. Refunding bonds that do not count towards the State ceiling are any obligations that are issued to refund another obligation to the extent that the refunding obligation does not exceed the then outstanding principal amount of the refunded obligation. In the case of student loan bonds, refunding bonds are not counted towards the State ceiling only if the maturity date of the refunding obigation is not later than the maturity date of the refunded obligation or the maturity date of the refunding obligation is not later than the date which is 15 years after the date on which the refunded obligation was issued (or, in the case of a series of refundings, the date on which the original obligation was issued). An obligation is a refunding obligation if the proceeds of the refunding obligation are used to retire the refunded obligation within 180 days of the date of issue of the refunding obligation.

Three-year carryover

The bill provides a special rule under which a State can elect to carryover for up to three years any unused State ceiling for specific projects. A special rule permits a longer six-year carryover for certain specifically identified air or water pollution control projects. Where the election applies, obligations issued in the three (six) calendar years following the calendar year for which the election is made are not counted towards the State's ceiling for those three (six) calendar years to the extent that the proceeds from those obligations are used to finance the project specified in the election.

The unused bond ceiling is absorbed in the order in which the obligations for the specified project are issued. The election is to be made in accordance with regulations to be prescribed by the Secretary of the Treasury. Identification of a project by its address, name of intended owner, lessee, etc., and general type of facility ordinarily will be considered adequate specification. An election, once made, is irrevocable. The purpose of issuing student loan bonds is considered a separate project which is adequately specified for purposes of any election.

2. Denial of tax-exemption for obligations issued with a Federal guarantee

The bill provides generally that interest on any obligation is not exempt from Federal income tax if the obligation is Federally guaranteed. An obligation is treated as Federally guaranteed if (1) the payment of the principal or interest on the obligation is guaranteed, in whole or in part, by the United States or any agency or instrumentality thereof, (2) a significant portion of the proceeds of the obligation are to be used in making loans or other investments the payments on which are guaranteed in whole or in part by the United States or any agency or instrumentality thereof, (3) a significant portion of the proceeds of the issue of which the obligation is a part are to be invested, directly or indirectly, in Federally insured deposits or accounts in a financial institution, or (4) the payment of the principal or interest of the obligation is otherwise indirectly guaranteed, in whole or in part, by the United States or an agency or instrumentality thereof. These rules apply to all obligations which are issued by or on behalf of States and their political subdivisions or otherwise described in section 103.

For purposes of these rules, an entity with statutory authority to borrow from the United States generally is to be treated as an instrumentaliity of the United States. In addition, a "Federally insured financial institution" means any bank, credit union, mutual savings bank, cooperative bank, domestic building and loan association, or other savings instituion whose deposits or accounts are insured under Federal law.

Federally insured deposits or accounts include any deposit or account in a financial institution to the extent the deposit or account is insured under Federal law by the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), the National Credit Union Administration (NCUA), or any similar Federally chartered corporation. This rule on investment of bond proceeds in Federally insured deposits or accounts applies to all IDBs and to qualified mortgage bonds and veterans' mortgage bonds.

Exceptions.—The bill provides a number of exceptions to the rules on Federal guarantees. First, the rule does not apply to any obligations which would be treated as Federally guaranteed solely because the loans financed with the tax-exempt bond proceeds are guaranteed by the Federal Housing Administration, the Veterans' Administration, the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Government National Mortgage Association (Ginnie Mae), the Student Loan Marketing Association (Sallie Mae), or the Small Business Administration (for bonds used to finance air or water pollution control facilities) or to any guarantee of student loans.

Second. the rule does not apply to any obligation to the extent that any proceeds of the obligation are invested in Federal obligations during an initial temporary period or to investments during periods necessary to maintain adequate funds in a bona fide debt service fund (under sec. 103 (c)(4)(b)). The rule also does not apply to the extent the bond proceeds are invested in obligations of the United States Treasury (e.g., an advance refunding) or invested otherwise as permitted under Treasury regulations.

An additional exception is provided for guarantees in connection with obligations the proceeds of which are used to finance projects for multifamily residential rental property (as described in sec. 103(b)(4)(A)) or in connection with a public housing program obligation (under sec. 11(b) of United States Housing Act of 1937). A similar rule is provided for qualified mortgage bonds and qualified veterans mortgage bonds (sec. 103A). Therefore, interest on bonds the proceeds of which are used to finance both multifamily rental housing and single family owner-occupied housing may be tax-exempt even if the underlying mortgages are pooled and repayment of the pooled mortgages is Federally guaranteed. This exception does not apply, however, to any obligation, the proceeds of which are invested in a Federally insured deposit or account.

Another exception to the general denial of tax-exemption provides that obligations shall not be treated as Federally guaranteed solely because the proceeds are used in making loans to financial institutions (e.g., as part of a loans to lenders programs) or because such a financial institution guarantees repayment of the loans (e.g., issues a letter of credit).

Finally, the bill provides that the District of Columbia or any U.S. possession (including Puerto Rico, the Virgin Islands and Guam) is not to be considered an instrumentality of the United States, under the rules pertaining to Federal statutory authority to borrow from the United States. However, this amendment does not apply in the case of private activity bonds (e.g., IDBs or student loan bonds). Thus, under the bill the District of Columbia or a U. S. possession having statutory authority to borrow from the U. S. may issue tax-exempt bonds other than private activity bonds subject to the the same limitations (other than the rule pertaining to authority to borrow from the United States) which are applicable to obligations issued by States. In addition, the District of Columbia or a U.S. possession may issue private activity bonds if the bonds are not guaranteed by the governmental entity involved, determined under the general rules regarding Federally guaranteed obligations (e.g., revenue bonds backed by revenues from the financed project rather than the revenues of the issuing government).[25B]

3. Other limitations on the use of IDBs

a. Restrictions on use of small issue IDBs where beneficiary has significant IDB use

The bill provides rules which restrict the amount of small issue IDBs that can be issued for a particular beneficiary of IDBs where that beneficiary has received the benefit of a significant amount of IDBs. Under the bill, tax-exempt small issue IDBs could not be issued if the total amount of all IDBs that would be outstanding after the issue for the beneficiary who would be the beneficiary of the small issue IDBs exceeds $40 million. In determining whether the $40 million limit has been reached, all types of IDBs are counted. However, bonds which are to be redeemed with the proceeds of the small issue IDBs are not to be counted. A beneficiary is defined as any person who is a user of the bond-financed facilities. Additionally, all related parties are treated as one user.

The bill includes allocation rules for applying the $40 million limitation. Under these rules, where 50 percent or more of the facilities financed by the issue are used by one beneficiary, the entire amount of the issue is to be allocated to that beneficiary. Where no beneficiary uses 50 percent or more of the facilities, the amount of the issue is to be allocated equally among beneficiaries who use at least 25 percent of the facilities; this allocation is not to exceed 50 percent for each such beneficiary. Any amount not allocated under these rules is to be allocated to any person who is a beneficiary by reason of owning the facilities being financed by the issue and renting the facilities to other persons.

b. Restrictions on use of IDBs for purchase of land or existing facilities

Nonagricultural land.—The bill permits the use of IDB proceeds for the purchase of nonagricultural land when not more than 25 percent of the proceeds are allocable to the cost of such land. The terms of the bond indenture generally will govern in determining which proceeds are allocable to the purchase of land. If the inden-

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[25B] General obligations of the District of Columbia shall not be deemed to be directly or indirectly guaranteed by the United States merely because the Department of the Treasury has agreed to pay or guarantee payment of such obligations in the event the courts determine that such obligations are not valid and binding obligations of the District because of the effect of the *Chadha* case on the D.C. home rule provisions.

ture makes no provision for this allocation, the proceeds will be deemed to have been used for the purchase of land and other facilities in relation to the relative fair market values of the properties involved. The committee intends that, in applying this restriction, expenditures nominally related to land, but which are eligible for cost recovery deductions, such as irrigation ditches, are to be treated as made for property other than land.

Existing facilities.—The bill generally prohibits the use of IDB proceeds to acquire existing facilities. However, the bill includes an exception permitting the acquisition of existing facilities if expenditures equal to at least 15 percent of the purchase price of the existing facilities are made for rehabilitation. Rehabilitation expenditures need not be financed by tax-exempt bond proceeds. The costs of rehabilitating an existing building purchased as part of the facilities and of rehabilitating or replacing substantially similar equipment which was part of an integrated operation contained in the building prior to its acquisition are included for purposes of determining whether the 15-percent requirement is satisfied. Additionally, under this provision, expenditures for building fixtures (e.g., stoves, refrigerators, and carpeting) are treated as expenditures for rehabilitation of the building. Purchase of existing facilities other than a building is prohibited unless the other facilities (i.e., equipment) are functionally related to and purchased with an existing building.

Rehabilitation expenses must be incurred by the person acquiring the building. Only those rehabilitation expenditures incurred within two years after the building is acquired, or the date the bonds are issued (if later), are considered in determining whether rehabilitation expenditures equal at least 15 percent cost of the building (and equipment) . For example, if a building were purchased for $500,000 and existing equipment in the building were purchased for $250,000, IDB financing would be available if at least $112,500 were expended for rehabilitation of the building and equipment.

In addition to nonagricultural existing facilities, tax-exempt bond proceeds may be used to acquire existing facilities (other than land) used in farming if the rehabilitation requirement is met. This use of tax-exempt financing is not restricted to first time farmers, who are the only individuals eligible for such financing for farmland.

First-time farmer exception—The bill includes an alternative exception to the land and existing facility rule for first-time farmers. This first-time farmer exception applies to both agricultural land and existing facilities used in connection therewith. Under the exception, IDB proceeds may be used for the purchase of agricultural land and existing facilities to the extent that such expenditures with respect to any individual do not exceed $250,000. The exception applies to facilities other than land only to the extent that the other facilities constitute existing real property improvements located on the land. In applying the $250,000 limit, expenditures by an individual's parents, spouse, and dependent children will be treated as made by the individual.

Property purchased under the first-time farmer exception must be acquired by an individual who will participate materially and substantially *on the farm* in the farming operation of which the property is to be a part. This requirement is intended to restrict availability of the exception to individuals who generally will perform substantial physical work in the farming operation.

A first-time farmer eligible for IDB financing means any individual who has not at any time had any direct or indirect ownership in land used for farming purposes in a farming operation in which the individual (or the individual's spouse or minor children) have materially participated. This definition permits individuals who have previously owned farm equipment and such real property improvements as sheds to house the equipment and have used those facilities as part of a farming operation involving only leased land to qualify as first-time farmers.

c. Denial of tax-exempt IDB financing for certain facilities

The bill provides that interest on IDBs is not exempt from Federal income tax if any portion of the proceeds of the IDB are to be used to provide any airplane, skybox or other private luxury box, any facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off-premises. This prohibition applies to exempt purpose IDBs and to small issue IDBs.

In the case of skyboxes or other private luxury boxes, the committee does not intend to prohibit the use of IDBs to finance the construction, renovation or refurbishing of a facility solely because skyboxes are included in the project, so long as the project otherwise qualifies for tax-exempt financing. Rather, no portion of the proceeds of the IDB may be used to provide any skybox. For this purpose, the skybox shall be deemed to include the interior furnishing of the box (*e.g.,* the box's plumbing, electrical and decorating costs) and the structural components required for the box (*e.g.,* the box's walls, ceilings, special enclosures), but does not include the normal components of the stadium, such as structural supports, to the extent they would have been required for the remaining portion of the stadium if no skyboxes (and no regular seats in lieu of skyboxes) had been built.

d. Extension of Internal Revenue Code rules to certain obligations

The bill extends certain Internal Revenue Code rules relating to tax-exempt obligations to bonds which are described in provisions of Federal law outside of the Internal Revenue Code. The rules extended to these obligations are (1) the rules relating to industrial development bonds, arbitrage bonds, and mortgage subsidy bonds; (2) the public approval requirements and information reporting requirements of present law; (3) the requirement that obligations be in registered form, (4) the disallowance of tax-exemption for obligations which are Federally guaranteed and (5) the volume limitations applicable to certain IDBs and student loan bonds. In the case of obligations issued by U.S. posessions (including Puerto Rico, the Virgin Islands and Guam), the volume limitations are to be applied as if those units were States. Under this amendment, interest on the obligations described in those non-Code provisions would not be exempt from Federal income tax unless the obligations complied with the rules described above.

e. *Restriction on cost recovery deductions for property financed with IDBs*

The bill repeals three of the four exceptions to the rule requiring the cost of IDB-financed property to be recovered on the straight-line method over the applicable ACRS period. The exceptions removed by the bill are those for certain municipal sewage and solid waste disposal facilities, certain pollution control facilities on existing property, and certain UDAG assisted projects. Under the bill, the cost of these facilities must be recovered over the straight line method over ACRS periods. However, the cost of multifamily rental housing will continue to be recovered using the accelerated cost recovery rule under the ACRS system.

f. *Application of small issue IDB limits to entire project*

The bill provides a special rule which prevents avoidance of the limitations on small issue IDBs through division of the ownership of a project. Under the rule, where two or more issues of IDBs are used to finance a single building, an enclosed shopping mall, or a strip of offices, stores, or residential property which use substantial common facilities, the two or more issues are treated as a single issue for purposes of determining qualification under the small issue exception, and all principal users of any of the facilities financed with the issue are treated as principal users of a single facility. Thus, under the rule, where ownership of a project is divided among several different unrelated users, qualification under the small issue exception is to be determined by measuring the capital expenditures and outstanding obligations of all the principal users of that project.

Examples of common facilities include situations where there are (1) common heating, cooling and other facilities or (2) common entrances, plazas, malls, lobbies, parking, elevators, and stairways for use by employees or patrons of the facilities. In order for there to be common facilities, the two facilities used by the different users generally must be contiguous. For example, all units in a strip shopping center which use a common parking lot would be treated as a single facility (regardless of whether the strip shopping center is physically divided into more than one structure) because the structures are essentially contiguous to each other. However, two or more stores located in a downtown redevelopment project which are not contiguous to each other generally would not be treated as a single project. Structures which are separated by inconsequential barriers, such as rights of way, are treated as contiguous for this purpose.

The committee anticipates that the Treasury Department will issue regulations defining circumstances where, because use of common facilities is *de minimis*, otherwise separate facilities will not be treated as a single project. For example, separate department stores that each lease less than 25 percent of an independently owned parking garage adjoining them should not be treated as a single facility. Likewise, use of utility facilities, such as the same local district heating and cooling system, by otherwise separate businesses is not in itself sufficient to treat the buildings used by the businesses as a single project.

g. Extension of substantial user rule to all partners

The bill amends the rules of present law under which interest on IDBs is not exempt from Federal income tax to the extent that the bonds are owned by a substantial user of the facilities financed with the IDB or the holder is a related person to that substantial user. Under the amendment, all partners (including both general and limited partners) of a partnership and spouses and dependent children of partners are treated as related persons to the partnership. Thus, interest on IDBs held by any partner of a partnership that is a substantial user of the facilities financed with the IDB would not be exempt from Federal income tax.

h. Clarification that residential rental property may be in a mixed use structure

The bill clarifies present law to provide that facilities may be residental rental property for low or moderate income persons even though not all of the building is used for residential rental use. Thus, a building may qualify for residential rental property (described in section 103(b)(4)(A)) even though all or a portion of the bottom floor is used for commercial use. However, in such a case, only the portion actually used for residential rental use qualifies as tax-exempt financing under section 103(b)(4)(A). In addition, the committee intends that, in determining the amount of facilities that are described in section 103(b)(4)(A), the cost of property that benefits both uses must be properly allocable between those uses. For example, where a portion of a building is used for commercial purposes and another portion of that building is used for residential rental purposes, a proper portion of the cost of the building's foundation and other common items must be allocated to the commercial use and the residential rental use.

i. Increase in amount of capital expenditures not taken into account where there is an Urban Development Action grant

The bill increases the maximum amount of capital expenditures that are not taken into account in meeting the $10 million limit on small issue IDBs in the case of facilities to which an urban development action grant (UDAG) has been made from $10 million to $15 million. In addition, the bill codifies the rule of present law that the size of the UDAG must be at least 5 percent of the reasonable estimate of the cost of the project.

The determination of whether the 5-percent test is satisfied is to be made at the time the UDAG is preliminarily approved by the Department of Housing and Urban Deveopment. In determining whether the 5-percent test is satisfied in the case of a UDAG in the form of a loan, the full amount of the loan is counted towards meeting the 5 percent test only if the rate of interest on the loan is significantly below the fair market rate and the maturity of the loan is at least 5 years. In addition, the committee intends that this exception apply only to projects with respect to which the UDAG was specifically made.

j. Public approval requirement in case of certain airport facilities

The bill provides a special rule under which the public approval requirement is deemed to be satisfied in the case of IDBs issued to finance a public airport where the governmental unit which is the owner or operator of the airport and is the issuer of the bonds properly approves the issue, even though all or a portion of the airport is located in the jurisdiction of other governmental units which have not properly approved the issuance of the IDBs.

k. Repeal of advance refunding for qualified public facilities

The bill repeals the provision of present law permitting advance refunding of IDBs, the proceeds of which are used to finance convention and trade show facilities (sec. 103(b)(4)(C)) and airports, docks, wharves, mass commuting facilities, parking facilities (and storage and training facilities related thereto) (sec. 103(b)(4)(D)).

4. Extension of mortgage subsidy bond arbitrage rules to IDBs and student loans

The bill provides that, pursuant to Treasury Department regulations, rules similar to the arbitrage rules of present law relating to mortgage subsidy bonds are to be applied to IDBs and student loan bonds. However, in the case of student loan bonds, the bill continues the present rule under section 103(c) that excludes payments made by the Secretary of Education pursuant to section 438 of the Higher Education Act of 1965 from the arbitrage computation. As under the present law mortgage bond arbitrage rules, fees and other charges paid by the beneficiary of the bonds are excluded if they are reasonable and would have been incurred if conventional financing were used.

The new arbitrage rules will not apply to IDBs, the proceeds of which are used to finance multifamily residential rental property under section 103(b)(4)(A). Similarly, the new provision does not apply to public housing program obligations issued under section 11(b) of the United States Housing Act of 1937. Finally, an exception is provided for obligations issued to refund student loan bonds where (1) the obligations to be refunded were issued before January 1, 1986, (2) the amount of the refunding bonds does not exceed the outstanding amount of the refunded obligations, and (3) the maturity of the refunding obligations does not exceed the greater of the maturity date of the refunded obligation or 15 years after the date the original issue occurred.

Effective Dates

Private activity bond ceiling

The ceiling on the volume of certain IDBs and student loan bonds that States and their political subdivisions may issue applies generally to obligations issued after December 31, 1983.

The bill provides a special rule which requires that, in certain cases, priority over other projects be given to projects for which an inducement resolution (or other comparable preliminary approval) was granted before October 19, 1983, by the issuing governmental unit which granted the inducement resolution (or other comparable preliminary approval). Sponsors of such projects have 30 days from the date of enactment to notify an issuing authority of their intention to exercise their claim to priority. If the governmental unit granting the inducement resolution does not provide priority over other projects, the authority of that governmental unit is reduced in the next subsequent calendar year. Where there are more projects which receive priority than that governmental unit has authority to finance, the priority shall be granted first to those projects for which substantial expenditures were incurred before October 19, 1983. A governmental unit cannot avoid this rule by transferring all or a part of its authority to another governmental unit. However, the priority rule can be overridden by a specific State statute.

Other limitations

Restrictions on cost recovery deductions for property financed with IDBs

The provision that restricts the cost recovery deductions of property financed with IDBs generally applies to property placed in service after December 31, 1983, to the extent that such property is financed by the proceeds of IDBs (including a refunding obligation) issued after October 18, 1983.

However, the restrictions on cost recovery deductions do not apply to facilities placed in service after December 31, 1983, if the original use of the facilities commence with the taxpayer and either—

(1) the construction of the facilities had commenced before October 19, 1983, or

(2) a binding contract existed before October 19, 1983, and at all times thereafter which committed the purchaser to incur significant expenditures for construction or acquisition of the facilities.

The restrictions on cost recovery deductions also do not apply to property placed in service after December 31, 1983, to the extent that property is financed with tax-exempt bonds issued before October 19, 1983. For purposes of this exception, a refunding issue issued after October 18, 1983, generally is treated as a new issue and the taxpayer must use the slower recovery methods for costs that are unrecovered on the date of the refunding issue. If significant expenditures were incurred with respect to the facility before January 1, 1984, and the original use of the facility commences with the taxpayer, however, such a refunding issue will not be treated as a newissue and accelerated cost recover methods may continue to be used.

In cases where a change of recovery method is required because of a refunding issue, only the remaining unrecovered cost of the property is required to be recovered using the slower method and period. Therefore, no retroactive adjustments to cost recovery deductions previously claimed are required upon a refinancing of a pre-October 19, 1983 issue where no significant expenditures are made with respect to the facility after December 31, 1983.

Other rules

The provisions of this title of the bill other than the restrictions on cost recovery deductions and the repeal of advance refunding for qualified public facilities generally apply to obligations including refunding obligations issued after December 31, 1983. However, under a special effective date, the portion of the provision denying tax-exemption to interest on obligations which are Federally guaranteed which relates to obligations issued in conjunction with Federally insured deposits or accounts in financial institutions applies to obligations issued after April 14, 1983.

Additionally, these restrictions do not apply to a facility—

(1) if the original use of the facility commences with the taxpayer and the construction, reconstruction, or rehabilitation of which begun before October 19, 1983, or

(2) with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983.

For purposes of the above rules, an expenditure is considered significant if the expenditure is equal to the lesser of $15 million or 20 percent of the estimated cost of the facilities. In addition, the amount of any UDAG grant preliminarily approved on May 5, 1981 or April 4, 1983, shall be treated as a qualified expenditure before October 19, 1983, for purposes of satisfying the binding contract rule with respect to the facility for which such grant was so approved.

Whether or not an arrangement between a purchaser and contractor or seller constitutes a contract is to be determined under the applicable local law. A binding contract is not considered to have existed on October 18, 1983, however, unless the property to be acquired or service to be rendered was specifically identified or described before that date.

A binding contract for purposes of this provision exists only with respect to property or services which the taxpayer is obligated to pay for under the contract. In addition, where a contract obligates a taxpayer to purchase specified number of items and also grants an option to purchase additional items, the contract is binding on the taxpayer only to the extent of the items that must be purchased.

A contract may be considered binding on the taxpayer even though (1) the price of the item is to be acquired or services rendered under the contract is to be determined at a later date, (2) the contract contains conditions the occurrences of which are under the control of a person not a party to the contract, or (3) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

A contract which was binding on the taxpayer on October 18, 1983, will not be considered binding at all times thereafter if it is substantially modified after that date. Additionally, a contract under which the taxpayer has an option to acquire property is not a contract that is binding on the taxpayer for purposes of this exception unless the amount paid for the option is forfeitable and is more than a nominal amount.

Finally, all property which is part of facilities described in an inducement resolution (or other comparable preliminary approval) adopted before October 19, 1983, pursuant to which the bonds are issued, is to be treated as under construction by October 19, 1983, where any part of those facilities are under construction before October 19, 1983. Moreover all such property is included under this transitional rule even though part of the facilities are transferred by the taxpayer prior to their being placed in service and even though properties which are part of the facilities are placed in service before the completion of construction of other properties which are part of those facilities.

Repeal of advance refunding for qualified public facilities

The provision repealing advance refunding for qualified public facilities applies to refunding obligations issued after the date of the provision's enactment.

Special rules

The bill also provides special transitional rules under which certain projects are to be exempt from some or all of the restrictions provided by this title of the bill.

Revenue Effect

This provision is estimated to increase fiscal year receipts by $30 million in 1984, $142 million in 1985, $364 million in 1986, and $599 million in 1987.

C. Tax-Exempt Status of Obligations of Certain Educational Organizations

(Sec. 731 of the bill)

Present Law

Under present law, interest on State and local government obligations generally is exempt from Federal income tax.

Treasury regulations provide that State and local obligations include obligations issued by or on behalf of a State or local governmental unit by authorities empowered to issue such obligations. Treas. Reg. sec. 1.103-1(b). The courts have held that whether an obligation has been issued by a State or local government unit depends on a variety of factors, including the degree of sovereign power exercised by the issuing authority and the relationship of the authority to the State or local government.[26] Similarly, several requirements must be satisfied in order for an issuer to qualify as a constituted authority that is issuing obligations on behalf of a State or local governmental unit. (See Rev. Rul. 57-187, 1957-1 C.B. 65; Rev. Rul. 63-20, 1963-1 C.B. 26,[27]

Reasons for Change

The committee understands that, for technical reasons, interest on obligations of the Pennsylvania State University may not be exempt from Federal income tax because those obligations may not be issued by or on behalf of the Commonwealth of Pennsylvania. The committee has examined the operations of the Pennsylvania State University and its relationship with the Commonwealth of Pennsylvania and believes that the operations of the Pennsylvania State University are sufficiently a part of the operations of the Commonwealth of Pennsylvania and its relationship to the Commonwealth of Pennsylvania is sufficiently close that interest on obligations of the Pennsylvania State University should be exempt from Federal income tax.

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[26] *Commissioner v. Shamberg's Estate*, 144 F. 2d 998 (2d Cir. 1944), *cert. den.*, 323 U.S. 792 (1945); *Philadelphia Nat'l. Bank v. U.S.*, 666 F. 2d 834 (3d Cir. 1981), *cert. den.*, 102 S. Ct. 2904 (1982).

[27] See also, Prop. Treas. Reg. sec. 1.103-1(c)(2). These proposed regulations provided that those requirements are generally satisfied if: (1) the authority is specifically authorized pursuant to State law to issue obligations to accomplish public purposes of the unit; (2) the unit controls the governing board of the authority; (3) the unit has either organizational control over the authority or supervisory control over the activities of the authority; (4) any net earnings of the authority (beyond that necessary for retirement of the indebtedness or to implement the public purposes or program of the unit) may not inure to the benefit of any person other than the unit; (5) upon dissolution of the authority, title to all property owned by the authority will vest in the unit; and (6) the authority is created and operates solely to accomplish one or more of the public purposes of the unit specified in the authorization of the unit. The proposed regulations were withdrawn on December 16, 1983. The statement accompanying the withdrawal indicated that prior rulings relating to entities issuing obligations on behalf of a State or local governmental unit form the primary source of guidance on this question. 48 Fed. Reg. 55878 (Dec. 16, 1983).

Explanation of Provision

The bill provides that the Pennsylvania State University is to be treated as a State governmental unit for purposes of the tax-exempt bond provisions of the Internal Revenue Code (sec. 103). Interest on obligations of the Pennsylvania State University will thus qualify for tax exemption subject to the limitations applicable to obligations issued by a State (see, e.g., sec. 103(b) and (c)). The provision does not apply with respect to trades or businesses carried on by the Pennsylvania State University which would constitute unrelated trades or businesses under the provisions regarding unrelated business taxable income.

Effective Date

The bill applies generally to obligations to which the Internal Revenue Code of 1954 is applicable.

Revenue Effect

It is estimated that this provision will reduce fiscal year budget receipts by less than $10 million annually.

TITLE VIII—MISCELLANEOUS REVENUE MATTERS

A. Capital Gain Treatment for Portion of Gain on Sale of Condominium Units Converted from Existing Structures (Sec. 801 of the bill and new sec. 1257 of the Code)

Present Law

Taxation of capital gain

Under present law, gain or loss on the sale or exchange of a capital asset is treated as capital gain or loss. If a capital asset that is held for more than one year is sold or exchanged, the capital gain or loss is long-term. Long-term capital gain is taxed at preferential rates.

In general, a capital asset is any property owned by a taxpayer, whether or not connected with a trade or business, subject to certain exceptions. Under one of those exceptions, an asset is not a capital asset if it is stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or is property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business.

The question of whether or not property is held primarily for sale to customers in the ordinary course of a trade or business is one of fact. Among the factors considered in making this determination are the intent of the owner; whether the sale is merely the liquidation of an investment; whether there are sales activities such as development and improvement work on the property; whether there is promotional activity such as advertising, the use of salespersons, or payment of commissions; whether the proceeds are reinvested in like property; and whether the owner is a dealer in the trade or business. In general, see *Malat* v. *Riddell*, 383 U.S. 569 (1966), *vac'g and rem'g* 347 F. 2d 23 (9th Cir. 1965).

Section 1231

Another exception to the definition of capital asset is provided for depreciable property and real property used in the trade or business (sec. 1221(2)). Under this exception, such assets are not capital assets, and the sale or exchange of such assets do not result in capital gain or loss to the seller. However, under section 1231, if the recognized gains on the sale or exchange or involuntary conversion of such assets held for more than one year (not including inventory or property held for sale to customers in the ordinary course of a trade or business) exceed the recognized losses on such sales, exchanges, or conversions, all such gains and losses are treated as long-term capital gains and losses. If such gains do not exceed such losses, than all such gains and losses are treated as ordinary gains and losses.[1]

Section 1237

Present law also provides a special rule for determining whether or not taxpayers (other than dealers in real estate) are treated as holding real property for sale in the ordinary course of a trade or business (sec. 1237). If the requirements of section 1237 are met, and if more than five lots in the tract are sold or exchanged, then any gain realized in or after the taxable year in which the sixth lot is sold is treated as ordinary income to the extent of five percent of the sales price. Under this rule, if the first five or fewer lots are sold in any one year the entire gain on those lots is treated as capital gain.

In order to be eligible for this special treatment, the taxpayer must not have held the tract or any parcel thereof for sale in the ordinary course of a trade or business, and the taxpayer must not hold other real estate for sale to customers in the ordinary course of a trade or business in the year of sale. In addition, the taxpayer must not have made substantial improvements (other than necessary improvements and certain marketing expenditures) to the tract which substantially enhance the value of the lot or parcel sold. Furthermore, the taxpayer must have held the parcel sold for five years (except in the case of real property acquired by inheritance or devise).

The Internal Revenue Service takes the position that section 1237 does not apply to the conversion of rental units in an apartment building to condominiums for resale to the public (Rev. Rul. 80-216, 1980-2 C.B. 239). Thus, under present law, the sale of condominium units by a building owner generally does not qualify for capital gain treatment.

Reasons for Change

The committee believes that present law should be modified for several reasons.

First, the committee believes that in the case where a rental property owner who holds the property for investment (as opposed to resale) subdivides the property into condominium units and sells such units in the ordinary course of a trade or business, the seller should be accorded capital gain treatment on any gain on the sale or exchange of each such unit allocable to any pre-conversion appreciation in value of the property.

Second, the committee believes that present law provides an unwarranted incentive for landlords to sell their rental property to condominium converters or to engage in other transactions designed to protect the capital gain treatment for their pre-conversion accretions in value. Thus, in many cases, the effect of present law has been to cause a part of the income from the conversion of rental property to condominium units to be diverted to professional converters.

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[1] For example, if a building used in a trade or business (such as an apartment building) is sold or exchanged (or condemned) and the transaction results in a gain to the taxpayer, this gain will be taxed at capital gain rates (assuming sec. 1231 gains exceed sec. 1231 losses for that taxable year).

Third, the committee is concerned that the incentives in present law to use professional converters may result in greater inconvenience to tenants.

To remedy these problems, the bill allows certain taxpayers to elect to determine the character of that portion of their gain on the sale or exchange of condominium conversions which is attributable to pre-conversion appreciation in value as if they had sold the entire property to another person prior to conversion. In general, this would have the effect of protecting the capital nature of the property's appreciation prior to conversion.

The committee's bill generally treats condominium conversion as occurring on the earliest of (1) the day on which the taxpayer adopts a plan of conversion, (2) the day on which substantial improvements are begun in anticipation of conversion, or (3) the day on which the form of ownership of the property is changed into condominium units.

The committee is aware that, in some areas of the country, there is a practice of filing subdivision maps or like documents which convert the rental units into condominium ownership, not with the intent to sell the units but in order to preserve the option of subsequently selling condominium units if that should appear desirable at some time in the future. Accordingly, the bill provides that, where more than two years elapse between the adoption of a conversion plan and the sale of the second unit under such plan, the date of the sale of the second unit will generally be treated as the date of condominium conversion for purposes of the provision.

Explanation of Provision

Under the bill, in certain circumstances, a taxpayer may elect to treat a portion of the gain recognized from the sale or exchange of qualified condominium units as gain described in section 1231 (hereafter called "section 1231 gain"). This special treatment is provided even though the sale otherwise would be in the ordinary course of a trade or business.

This election applies on a property-by-property basis [2] with respect to the conversion of qualified real property. Qualified real property is real property which consists of one or more structures (and the land necessary for the use of such structures) which were used in a trade or business of the taxpayer at all times during the five-year period ending on the determination date (described below), with respect to which the taxpayer has made an election under this provision. A qualified condominium unit is any unit resulting from the conversion of qualified real property into condominium units. The election applies to the conversion of either commercial or residential property.

Under the bill, the total amount of the gain on the sale of all the units in any property which is treated as section 1231 gain (i.e., the

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[2] The committee intends that, for purposes of determining the property to which an election under this bill applies, each particular property which is a unit of an integrated project involving several properties of a similar kind will be treated as a single property. See, Treas. Reg. sec. 1.341-2(a)(4).

"imputed" gain) is equal to the excess (if any) of the fair market value of the property on the determination date over the adjusted basis of the property at such time, reduced by any amount which would be treated as ordinary income under the depreciation recapture provisions of sections 1245 and 1250. Any improvements to the property made in anticipation of the conversion would not be taken into account in determining the property's fair market value (or in determining its basis) on the determination date.[3] The total imputed gain amount is then allocated among each of the units in the project in proportion to their relative fair market values on the determination date.

Under the bill, this allocable capital gain amount is recognized on the sale or exchange of each unit, typically to the individual condominium purchaser. In addition, any ordinary income on the sale of the condominium inventory would be recognized at that time. If the ultimate sale of the property is for an amount less than the property's fair market value on the determination date there would first be a reduction of the imputed section 1231 gain and any additional losses would constitute ordinary losses.

In any case where the taxpayer's basis in the property is determined in whole or in part by reference to the basis of such property in the hands of another person, or when the property is acquired by inheritance or devise, the holding period and use of the property by the prior owner is combined with the holding period of, and use by, the taxpayer to determine if the five-year rule is met. If property with respect to which an election under this section has been made is transferred and the transferee's basis is determined (in whole or in part) by reference to the basis of the property in the hands of the transferor, any election under this section would continue to apply to the property in the hands of the transferee.

As used in the bill, the term "condominium" means an interest in real property consisting of two separate rights. First, the condominium unit owner must have an undivided interest in the common areas of the property and in the building. In addition, the unit owner must possess a separate right to occupy a space in the building located on the property. Finally, the condominium must meet the various requirements of local law relating to condominiums. See, Treas. Reg. sec. 1.528-1(b).

The bill defines the term "determination date" as the earlier of (1) the day on which the taxpayer adopts a plan to convert the property into condominium units, (2) the day on which substantial improvements of the property are begun in anticipation of the conversion or subdivision, or (3) the day on which the form of ownership of such property is changed into condominium units.

For purposes of tests (1) and (3), if more than two years elapse between the date on which a conversion plan is adopted and the date on which the second condominium unit is sold, the date on which the second unit is sold shall be substituted for the dates otherwise determined under these tests. The determination date will then be the earlier of the date on which the second unit is sold or the date determined under test (2). In determining the determination date, the committee expects that the Internal Revenue Service will require a filing evidencing any conversion plan and the adoption of such plan.

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[3] Such expenditures would be treated as attributable to the ordinary income portion of the sale's proceeds (if any).

The bill also provides that the amount of gain that otherwise would be treated as section 1231 gain, if an election under this provision is made, will be treated entirely or partly as ordinary income if the property is substantially overvalued on the determination date by the taxpayer on his tax return as filed. If the property is overvalued by more than 15 percent, the gain treated as section 1231 capital gain will be reduced by 20 percent for each full percentage point of overvaluation in excess of 15 percent. This test is an objective one which does not require the Internal Revenue Service to show any intent to overvalue by the property owner.

Effective Date

The provision applies to conversions after the date of enactment, in taxable years ending after such date.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $33 million in 1984, $72 million in 1985, $71 million in 1986, $53 million in 1987, $29 million in 1988, and $18 million in 1989.

B. No Gain Recognized from Net Gifts Made Before March 31, 1981 (Sec. 802 of the bill)

Present Law

For Federal income tax purposes, gross income means "all income from whatever source derived" (Code sec. 61). Income may be realized from a variety of indirect means as well as from direct transfers. For example, the benefit resulting from the discharge of one's indebtedness by another party constitutes gross income (sec. 61(a)(12); *Old Colony Tr. Co. v. Commissioner*, 279 U.S. 716 (1929); *Crane* v. *Commissioner*, 331 U.S. 1 (1947)).

Present law also imposes a gift tax on certain transfers for less than adequate consideration (sec. 2501). Responsibility for payment of the gift tax is on the donor of the transferred property (sec. 2502), and the gift tax is determined by reference to the value of the property transferred by the donor.

In most cases, the value of the transferred property does not include the amount of gift tax paid by the donor. However, a donor may transfer property pursuant to an agreement with the donee that the donee will pay any gift tax arising from the transfer. In such cases, the amount of the gift is less than the full value of the transferred property, and the donee discharges a debt of the donor with the balance of the transferred value (i.e., a "net gift" is made).

On June 15, 1982, the U.S. Supreme Court ruled in *Diedrich* v. *Commissioner*[1] that payment of gift tax by a donee results in income to the donor to the extent that the gift taxes exceeded the donor's adjusted basis in the transferred property.

Reasons for Change

Prior to the *Diedrich* decision, several courts had ruled that the transfer of property subject to the transferee paying any gift tax did not result in any amount realized by the transferor.[2] While the committee believes that the *Diedrich* decision is correct, it also believes that taxpayers should not be adversely affected because they may have made such transfers in reliance upon what was thought to be established law that no income tax liabilities would accrue from such transfers.

Explanation of Provision

The bill provides that payment of (or agreement to pay) gift tax by a donee with respect to gifts made before March 4, 1981,[3] does not result in income to the donor whose gift tax liability was thereby discharged. The provisions of the bill apply both to Federal gift tax and to any gift tax imposed on such transfers by a State. However, the bill does not apply where the gift tax actually was paid by the donor.

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[1] 457 U.S. 191 (1982).

[2] See, for example, *Turner* v. *Commissioner*, 410 F.2d 752 (6th Cir. 1969).

[3] March 4, 1981 was the date on which the U.S. Court of Appeals for the Eighth Circuit held that the donor in the *Diedrich* case was required to recognize income from the disputed transfers.

Effective Date

The provisions of section 802 of the bill are effective on the date of enactment. The period of limitations for filing a claim for refund is extended or reopened for up to one year after the date of enactment to permit a claim for refund to be filed in any case in which that period expired before that time.

Revenue Effect

It is estimated that the provision will reduce budget receipts by less than $5 million.

C. Disaster Loss Deduction Where Taxpayer Ordered to Demolish or Relocate Residence in Disaster Area Because of Disaster (Sec. 803 of the bill and sec. 165(k) of the Code)

Present Law

Deduction for casualty losses

The Internal Revenue Code generally does not allow a deduction for nonbusiness losses. However, taxpayers are allowed a deduction for losses not connected with a trade or business if such losses arise from fire, storm, shipwreck, or other casualty, or from theft (sec. 165(c)(3)). The deduction is allowed only to the extent that the loss from any individual occurrence exceeds $100. Additionally, the deduction is allowed only to the extent that the total amount of casualty and theft losses sustained during the taxable year exceeds 10 percent of the taxpayer's adjusted gross income (sec. 165(h)).

Treasury regulations provide that the amount which may be deducted for a nonbusiness casualty loss is equal to the lesser of (1) the difference between the fair market value of the property immediately before the casualty and the fair market value of the property immediately after the casualty, or (2) the taxpayer's adjusted basis for the property (Treas. Reg. sec. 1.165-7(b)).

Requirement of physical damage

The courts and the Internal Revenue Service have generally allowed a deduction for nonbusiness casualty losses only where the casualty (e.g. storm, flood, or earthquake) caused actual physical damage to the taxpayer's property. A decline in value of property as a result of dangerous conditions, rather than physical damage, has generally been held not to be a deductible casualty loss.

For example, in *Kamanski* v. *Commissioner*, 477 F.2d 452 (9th Cir. 1973), *aff'g* 29 T.C.M. 1702 (1970), the United States Court of Appeals for the Ninth Circuit held that taxpayers were not entitled to a deduction for a casualty loss on the sale of their property following a nearby mudslide. The Court held that the decline in value of the property did not result from damage caused by the mudslide itself, but from buyers' predictions of damage from future casualties.

Timing of deduction

Casualty losses generally are deductible in the year in which the casualty is sustained. Present law (sec. 165(i)) provides a special rule for determining the timing of a deduction for a loss attributable to a disaster occurring in an area subsequently determined by the President to warrant Federal assistance under the Disaster

Relief Act of 1974.[1] Under this rule, the amount of the loss may, at the election of the taxpayer, be taken into account in determining the taxpayer's liability for the taxable year immediately preceding the year in which the disaster occurred. The election must apply to the entire loss sustained by the taxpayer.

The special rule regarding Federally assisted disaster areas concerns only the timing of deductions. Thus, under present law, a taxpayer residing in a disaster area must establish the existence and amount of any loss under the general principles applicable to all taxpayers.

Reasons for Change

The committee is concerned that, in the case of certain natural disasters, casualty loss deductions have been allowed to taxpayers whose residences have been physically destroyed by the disaster, but not to taxpayers whose residences have been condemned because of a threat of further destruction, or because their residences have otherwise been rendered uninhabitable by the disaster. This occurs under present law even though both these groups of taxpayers are denied further use of their residences, and are subject to immediate and substantial economic loss, as a direct result of the disaster. The committee believes that these similarly situated classes of taxpayers should receive similar tax treatment. The committee further believes that the tax laws should not act to discourage the evacuation of dangerous residences by State and local authorities. Accordingly, the committee concluded that a deduction should be allowed to taxpayers who are ordered to demolish or relocate their residences as a proximate result of disaster conditions, whether or not the residences have been physically damaged.

In making the determination above, the committee is aware of the rule that allows nonbusiness casualty loss deductions only for sudden, unexpected losses, and denies a deduction for gradual declines in property values. The committee is also aware of the administrative difficulties that may result from too broad an expansion of the casualty loss deduction. Because of these considerations, the committee decided to place several limitations on the deduction allowed by the bill. First, the deduction is limited to residences located within a Federally declared disaster area. Second, a deduction is allowed only where the demolition or evacuation order is made by the appropriate State or local government, within a specified period. Finally, the deduction is limited to cases in which the taxpayer's residence has been rendered unsafe as a proximate result of the disaster. These requirements are designed to ensure that the deduction allowed by the bill remains consistent with the general rules for deducting nonbusiness casualty losses.

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[1] P.L. 93-288, 93d Cong., 2d Sess., May 22, 1974 (42 U.S.C. sec. 5121 *et seq.*). The Disaster Relief Act of 1974 empowers the President to declare an area affected by a disaster (including storms, floods, earthquakes, landslides, mudslides, hurricanes, tornadoes, fires, and explosions) either an "emergency" or a "major disaster" area. The declaration of an emergency permits the Federal government to take immediate steps to protect life, health and property, and to provide various forms of emergency assistance. Where a major disaster is declared, the Federal government is authorized to provide various additional forms of assistance, including financial assistance (such as grants and loans) to private parties affected by the disaster.

Explanation of Provision

The bill provides that certain taxpayers whose residences are located in an area determined to warrant Federal assistance under the Disaster Relief Act of 1974, and who are ordered to demolish or relocate their residences, may deduct any loss attributable to the disaster that caused the demolition or evacuation order as a casualty loss. The deduction is allowed for taxpayers (1) who are ordered by the State or local government, not later than 120 days after the Federal determination, to demolish or relocate their residences, and (2) whose residences have been rendered unsafe for use as a residence by reason of the disaster.

The committee intends that a deduction will be allowed only when a residence is rendered unsafe as a proximate result of the disaster (including, but not limited to, storms, floods, fires, earthquakes, mudslides, earthslides, hurricanes, lightning, and tornadoes). That is, the residence must be rendered materially more dangerous after the disaster than it was before the disaster, and the danger must be from a materially increased risk of future destruction arising from the disaster. For example, in a storm disaster area, a demolition or relocation order based on a finding that a residence was rendered unsafe by nearby mudslides would result in a deductible loss. By contrast, the decline in value of a residence as a result of pre-existing dangerous conditions (e.g., by reason of location in an historically storm-prone region) would not result in a deductible loss, even if the house is condemned.

The amount of any loss deductible under the bill is to be determined under the general rules applicable to nonbusiness casualty losses. Thus, the amount deductible equals the lesser of (1) the difference between the fair market value of the property immediately before the disaster and the fair market value of the property immediately after the disaster, or (2) the taxpayer's adjusted basis for the property. (The amount of the deduction would be reduced by any insurance or other compensation received with respect to the property, including any amount realized upon a condemnation sale.) In the case of a relocated residence, fair market value immediately after the disaster is to be determined based on the value of the residence prior to relocation. For example, if a residence has a fair market value of $100,000 immediately before a disaster, and a fair market value of $20,000 immediately after the disaster, the taxpayer would realize a loss of $80,000 (or, if less, an amount equal to the adjusted basis of the residence), regardless of the value of the residence in any new location. As under current law, the component of loss in value because of any general market decline affecting undamaged as well as damaged property, which decline may occur simultaneously with the disaster, is not deductible.

Amounts deductible under the bill are subject to the timing provisions of existing law for disaster losses. Thus, at the taxpayer's election, these amounts may be deducted on the taxpayer's return for the taxable year immediately preceding the year in which the order to demolish or relocate the residence was made.

Effective Date

The provision applies to taxable years beginning after December 31, 1981, with respect to areas determined after that date to warrant Federal disaster assistance.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $15 million in 1984, $12 million in 1985, $12 million in 1986, $13 million in 1987, $13 million in 1988, and $14 million in 1989.

D. Foreign Investment Companies (Secs. 101, 139, and 140 of the bill and secs. 535, 1092, and 1246 of the Code)

Present Law

U.S. taxation of foreign persons

Although U.S. corporations are subject to current U.S. taxation on worldwide income, foreign corporations are generally subject to U.S. taxation on only their U.S. source income and income from a U.S. business. Foreign corporations are generally exempt from U.S. taxation on foreign source income. A special rule applies, however, to income from the sale of commodities and futures contracts. Foreign corporations are taxable on their gains from the sale of commodities and futures contracts only when those sales are effectively connected with a trade or business in the United States. In general, by avoiding contacts with the United States, a company purchasing and selling commodities and futures contracts on U.S. markets may be able to avoid conducting a business in the United States and thus avoid U.S. tax (sec. 864(b)(2)(B)). In that event, gains from sales of commodities and futures contracts are exempt even though they have a U.S. source.

Dividends from one foreign corporation to another foreign corporation are taxable only if 50 percent or more of the paying foreign corporation's income from the last three years is U.S. business income, in which case the dividends are U.S. source income (in the same proportion as the gross income is U.S. business income) (sec. 861(a)(2)(B)).

Taxation of U.S. shareholders of foreign corporations

The United States generally imposes tax on the U.S. shareholder of a foreign corporation only when that shareholder receives the foreign corporation's earnings in the form of a dividend. That is, the U.S. shareholder of a foreign corporation generally may defer tax on that income until receipt of dividends.

The Subpart F provisions of the Code provide an exception to this general rule of deferral. Under these provisions, income from certain "tax haven" type activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them before they actually receive the income in the form of a dividend. For this purpose, tax haven activities generally include gains from trading in futures contracts in commodities. However, the Subpart F rules apply only if more than fifty percent of the voting power in the foreign corporation is owned by U.S. persons who own (directly or indirectly) at least ten percent interests in the corporation. (Even if ownership is so concentrated that the Subpart F rules apply, the rules apply only to those U.S. persons who are considered to own ten percent or more of the voting power in the foreign corporation.)

Two other, similar sets of rules, the personal holding company rules and the foreign personal holding company rules, could also subject foreign corporations or their U.S. shareholders to current taxation on passive investment income or futures trading income, but these rules apply only if five or fewer U.S. individuals own (directly or indirectly) more than fifty percent in value of the stock of a foreign corporation. In general, only one of these three sets of rules will apply to tax that income.

The accumulated earnings tax

The accumulated earnings tax is aimed at corporations accumulating income for the purpose of avoiding tax at the shareholder level. The accumulated earnings tax (which reaches a maximum rate of 38.5 percent) generally applies to a U.S. or foreign corporation formed or availed of for the purpose of avoiding the U.S. income tax on shareholders by accumulating earnings at the corporate level rather than distributing earnings.

Under Treasury Regulations, the tax does not apply to foreign source income (Treas. Reg. sec. 1.532-1(c)). It may be unclear whether a foreign parent corporation and a foreign subsidiary corporation (earning U.S. source income) from which the foreign parent receives dividends are subject to this tax, however. If the subsidiary distributes all its U.S. source earnings as dividends to its parent, those dividends are generally deductible from accumulated earnings. Therefore, there may be no accumulated earnings at the level of the subsidiary to which the accumulated earnings tax can apply. The parent corporation may avoid the accumulated earnings tax because all of its income is foreign source income (such as dividends from its subsidiary) not effectively connected with a U.S. trade or business.

The Internal Revenue Service may argue in such a case that imposition of an accumulated earnings tax on the earnings of either foreign corporation is appropriate. First, the statute and the Regulations allow imposition of the accumulated earnings tax if the avoidance of tax at the shareholder level is accomplished through the use of a chain of corporations (see Treas. Reg. sec. 1.532-1(a)(2)). Second, the Code gives the Treasury authority to disregard certain tax benefits associated with a corporation if the corporation was acquired for the principal purpose of evading or avoiding Federal income tax (sec. 269).

Shareholder level tax on disposition of the investment

Code rules attempt to prevent U.S. taxpayers from repatriating foreign earnings at the lower capital gains rates after deferring tax on those earnings. Gains of a U.S. person who was a ten-percent shareholder (during a five-year period) in a controlled foreign corporation on the disposition of that corporation's stock are subject to ordinary income (dividend) treatment rather than capital gains treatment to the extent of that person's share of the post-1962 earnings and profits of the controlled foreign corporation (sec. 1248). Wide dispersal of a foreign corporation's stock ownership can avoid controlled corporation status.

Another provision, the foreign investment company provision (sec. 1246), generally applies to any foreign corporation that is either (1) registered under the Investment Company Act of 1940 or (2) engaged primarily in the business of investing or trading in securities (as generally defined in that Act) when more than 50 percent of the corporation's stock (by value or by voting power) is held (directly or indirectly) by U.S. persons. When a U.S. person disposes of stock in a foreign investment company, that person is subject to ordinary income treatment to the extent of his share of the foreign investment company's earnings and profits. A foreign corporation that does not register under the Investment Company Act avoids the first of these criteria. In addition, certain case law holds that commodities do not constitute securities for purposes of that Act, so that a company that is engaged primarily in the business of investing or trading in commodities may avoid the second criterion.

Marking-to-market of futures trading income

The Economic Recovery Tax Act of 1981, Public Law 97-34, adopted a mark-to-market rule for the taxation of certain commodity futures contracts (Code sec. 1256(a)). Thus, each regulated futures contract held by a taxpayer is treated as if it were sold or otherwise liquidated for fair market value on the last business day of the year. A maximum rate of 32 percent applies to this income. U.S. taxpayers investing through a pass-through entity (such as a limited partnership) organized in the United States in such futures contracts would be subject to this mark-to-market rule.

Foreign corporations not engaged in U.S. trade or business are not subject to tax under the mark-to-market rule.

Straddles

The Code defines a straddle as offsetting positions with respect to personal property. Personal property is defined to include only property (other than corporate stock) of a type which is actively traded. A taxpayer is treated as holding offsetting positions with respect to personal property if there is a substantial reduction in the taxpayer's risk of loss from holding any position in personal property because the taxpayer holds one or more other positions with respect to personal property.

Generally, the deduction of losses on positions that are part of a straddle is limited to the amount by which those losses exceed unrecognized gains on any offsetting positions. Some taxpayers have deliberately arranged to hold offsetting positions indirectly through ownership of stock in corporations owning those positions to avoid the straddle rules. That is, a shareholder seeks to deduct losses despite unrecognized gains in the hands of the corporation that offset the shareholder's losses. Often, the corporations involved in the transactions are foreign, so as to avoid U.S. tax on the gains.

Reasons for Change

Background

A mutual fund may, using some of the rules described above, attempt to defer U.S. tax and to convert trading income (ordinarily taxed as 60 percent long-term gain and 40 percent short-term gain) to 100 percent long-term capital gain through the use of two foreign corporations, one of which ("the Parent") owns all the shares of the other ("the Subsidiary"). The fund establishes and operates these foreign corporations in tax haven jurisdictions, which impose no tax on their operations.

U.S. taxation of foreign persons

The Parent may trade in non-U.S. commodity markets (and will avoid having any U.S. source income), while the Subsidiary will trade in U.S. commodity markets (and will earn all the U.S. source income that either corporation earns). In general, by carefully structuring its activities, the Subsidiary may be able to avoid having a business in the United States and thus avoid U.S. tax on gains from commodity trading activities (sec. 864(b)(2)(B)).

The Parent may be able to avoid U.S. tax because it will be a foreign corporation with no U.S. source income. Its income will consist mainly of (1) dividends from the Subsidiary, which should not be U.S. source, and (2) gains from trading on non-U.S. commodities markets, which will result in foreign source income.

Taxation of U.S. shareholders of foreign corporations

The fund may plan to avoid U.S. shareholder level tax on the earnings of the Parent and the Subsidiary by having the Parent distribute no dividends. Shareholders will have to dispose of their shares to receive any income.

To decontrol these corporations for purposes of the anti-tax avoidance rules including the controlled foreign corporation rules, the Parent will restrict transfers of its shares, and it will attempt to spread ownership of its shares by U.S. persons among many such persons.

Accumulated earnings tax

The fund may plan its operations so as to try to avoid the accumulated earnings tax. It may try to benefit from the general rule that the tax does not apply to foreign source income. This is one of the primary reasons to set up two foreign corporations (the Parent and the Subsidiary) rather than one. The parties involved will argue that the Subsidiary will not be subject to the tax because it will distribute all its U.S. source earnings as dividends to the Parent. The fund will argue that there are no accumulated earnings at the level of the Subsidiary to which the accumulated earnings tax can apply. The fund seeks to avoid the accumulated earnings tax at the level of the Parent by having all the Parent's income be foreign source income.

The validity of these positions under current law, however, is unclear, and the Internal Revenue Service may argue that imposition of an accumulated earnings tax on the earnings of the Parent or the Subsidiary is appropriate.

To avoid potential challenges to its position on the accumulated earnings tax, the fund may allege that its corporate structure has no tax avoidance purpose. The issue would be one of intent.

Shareholder level tax on disposition of the investment

Under this plan, the shareholder realizes income from the investment by disposing of the interest in the offshore corporation rather than by being paid the earnings. A major element in this plan is to permit U.S. investors in the fund to realize capital rather than ordinary gain from their investment when they sell. Such treatment would circumvent the Code's rules that attempt to prevent U.S. taxpayers from repatriating foreign earnings at the lower long-term capital gains rates after deferring tax on those earnings. The fund would plan to avoid this rule by causing such wide dispersal of the Parent's stock ownership as to avoid controlled foreign corporation status.

The fund would plan to avoid the foreign investment company provision (sec. 1246) by failing to register the Parent or the Subsidiary under the Investment Company Act and by relying on case law that holds that commodities do not constitute securities for purposes of that Act.

Marking-to-market of futures trading income

U.S. investors could avoid the mark-to-market rule by interposing foreign corporations between themselves and the investments. A similar result could be achieved through the use of a domestic corporation at the investor's level, but the corporation would be subject to the mark-to-market rules.

Committeee concerns

The committee is concerned that the abusive use of tax havens by U.S. persons, through transactions like those described above, poses a significant threat to the U.S. tax base. While the committee recognizes legitimate uses of tax haven entities, it also recognizes that any use of tax haven entities must be carefully scrutinized. Particularly troublesome are those cases in which U.S. taxpayers use a foreign entity, which is not much more than a conduit, to shield U.S. income from U.S. tax.

Such a situation has come to the attention of the committee with the result that the committee has reviewed certain anti-abuse provisions of the Code and has found loopholes that should be closed. In particular, the committee believes that for purposes of insuring that investment income of a U.S.-controlled foreign investment company cannot be converted to capital gain, no distinction should be made between security transactions and other investment transactions. Accordingly, the committee expanded the scope of the foreign investment company rules.

Also, the committee believes it inappropriate to defer U.S. tax on the U.S. earnings of a foreign company, or to permit mere receipt of U.S.-source income by a foreign corporation and its payment to another foreign corporation controlled by U.S. persons to change the source of that income. Accordingly, the committee has amended the accumulated earnings tax rules to insure U.S. tax in such cases.

Finally, the committee believes that transparent devices, such as the use of a corporation to avoid the straddles rules, cannot be tolerated.

Explanation of Provision

1. Definition of foreign investment company (sec. 139 of the bill and sec. 1246 of the Code)

The bill expands the definition of "foreign investment company" (sec. 1246), for purposes of determining when gain on the sale of shares of that stock will be ordinary rather than capital. A foreign investment company will include any foreign corporation that is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, commodities, or any interest (including a futures or forward contract or option) in commodities or securities, at a time when 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, is held directly or indirectly by U.S. persons. For this purpose, "securities" are defined in section 2(a)(36) of the Investment Company Act of 1940, as amended. If that definition in the Investment Company Act is amended in the future, then the definition for Internal Revenue Code purposes will also change. A primary effect of this provision is to bring commodity trading companies within the definition of foreign investment company. The bill will generally not affect the treatment of foreign corporations registered under the 1940 Act.

Effective date.—The provision will generally apply to sales and exchanges (and distributions) after September 29, 1983. In the case of shares held on September 29, 1983, and held continuously thereafter by one taxpayer until sale, exchange, or distribution, however, the bill will apply to sales and exchanges (and distributions) made after one year after date of enactment.

2. Extension of accumulated earnings tax to U.S.-owned foreign corporations (sec. 140 of the bill and sec. 535 of the Code)

The bill makes it clear that U.S. persons cannot use two or more tiers of foreign corporations to avoid the accumulated earnings tax on certain U.S. earnings. For purposes of the accumulated earnings tax rules (secs. 531-537), if more than 10 percent of the earnings and profits of any foreign corporation for any taxable year are derived from sources within the United States or are effectively connected with the conduct of a trade or business within the United States, then any distribution received (directly or indirectly) by a United States-owned foreign corporation out of those earnings and profits will be treated as derived by the receiving corporation from sources within the United States. That is, the earnings become U.S. source earnings in the hands of the receiving (upper-tier) corporation, so that they will be subject to the accumulated earnings tax. The accumulated earnings tax can apply to any U.S.-source earnings of foreign corporations, whether or not the earnings are, or are viewed as, effectively connected. A similar rule applies to interest paid by a foreign corporation. If the paying corporation meets the 10-percent earnings and profits threshhold, all interest it pays to a U.S.-owned foreign corporation is U.S. source income for the purpose of the accumulated earnings tax.

The bill defines the term "United States-owned foreign corporation" to mean any corporation if 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, is held directly or indirectly by U.S. persons. The bill will apply only to foreign corporations. It will apply to closely held and publicly held foreign corporations alike.

Effective date.—This provision will apply to distributions received by a United States-owned foreign corporation on or after May 23, 1983. In the case of a foreign corporation that was a United States-owned foreign corporation on May 23, 1983, however, the provision will first apply in the first taxable year of the foreign corporation that begins after December 31, 1984.

3. Treatment of offsetting position stock (sec. 101 of the bill and sec. 1092 of the Code)

The bill expands the definition of personal property, for purposes of the straddle rules (sec. 1092), to include offsetting position stock. It defines offsetting position stock to mean any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by shareholders. This rule applies to both U.S. and foreign corporations. Therefore, a taxpayer would be required to defer losses if offsetting position stock contained unrealized gains for him or her.

Effective date.—This provision applies to positions established after May 23, 1983.

Effective Date

The effective dates for these provisions are included above in the "Explanation of Provision."

Revenue Effect

It is estimated that these provisions will increase budget receipts by $10 million annually.

E. Application of Cash or Deferred Arrangement Rules to Pre-ERISA Money Purchase Plans (Sec. 804 of the bill, and sec. 401(k) of the Code)

Present Law

In general

A money purchase pension plan is a defined contribution plan under which each participant's pension benefit is based solely on the balance of the participant's account, consisting of contributions, income, gain, expenses, and losses. Profit-sharing plans are also defined contribution plans.

Under a cash or deferred profit-sharing plan, or under a money purchase pension plan with a salary reduction arrangement, the employer gives an employee the choice of (1) receiving a specified amount in cash as current compensation or (2) having that amount contributed by the employer to the plan.

In December 1972, the Internal Revenue Service issued proposed regulations which called into question the tax treatment of cash or deferred profit-sharing plans and money purchase pension plans with salary reduction arrangements. (These proposed regulations were withdrawn in July, 1978.) Under the rules in effect at the time of the proposal, an employee generally was not taxed currently on amounts the employee chose to have contributed to a tax-qualified cash or deferred profit-sharing plan or salary reduction money purchase pension plan. Under the proposed regulations, amounts contributed to a plan by the employer due to the election of the employee would be included in the employee's income.

Freeze on tax treatment

In order to allow time for Congressional study of this area, the Employee Retirement Income Security Act of 1974 (ERISA) provided that the tax treatment of contributions to cash or deferred profit-sharing plans or salary reduction money purchase plans in existence on June 27, 1974, was to be governed under the law as it was applied prior to January 1, 1972. Accordingly, employer contributions to these cash or deferred profit-sharing plans were not includible in the income of covered employees, provided the plans satisfied the requirements of pre-1972 law and otherwise complied with the tax-qualification rules. Under ERISA, this freeze in tax treatment was continued through 1976, or (if later) until regulations were issued in final form which would change the pre-1972 administration of the law. The freeze was subsequently extended through 1979.

Revenue Act of 1978

The Revenue Act of 1978 provided rules for new and old profit-sharing plans with cash or deferred arrangements. The new rules, which also apply to stock bonus plans, are effective for plan years beginning after 1979. For years beginning before 1980, the tax treatment under a plan in existence on June 27, 1974, is determined under prior law. No new rules were provided by the 1978 Act for salary reduction arrangements under money purchase pension plans.

Reasons for Change

The committee is concerned with the revenue loss associated with the increasing use of salary reduction agreements in connection with cash or deferred arrangements. The committee believes, however, that permanent rules should be provided for a pre-ERISA money purchase pension plan with a salary reduction feature as long as these plans are maintained at the pre-ERISA contribution levels.

Explanation of Provision

The provision revises the tax-qualification rules to permit a qualified money purchase pension plan which was in existence on June 27, 1974, and which provided for a salary reduction arrangement on that date, to continue the arrangement after 1979. However, this revision to the tax-qualification rules will apply only to those money purchase pension plans under which employer and employee contributions may not exceed the limits (e.g., the percentage of pay) provided under the plan's contribution formula on June 27, 1974.

In addition, for plan years beginning after 1983, a salary reduction arrangement under a money purchase pension plan must meet the special tax-qualification rules for cash or deferred arrangements added by the 1978 Revenue Act with respect to employee eligibility to participate in the arrangement and to prohibited discrimination in favor of employees who are officers, shareholders, or highly compensated. These rules presently apply to cash or deferred arrangements under qualified profit-sharing or stock bonus plans.

The provisions of the bill apply to salary reduction arrangements under money purchase pension plans of taxable employers and tax-exempt organizations.

Effective Date

The bill will apply for plan years beginning after the date of enactment. The rules in effect prior to ERISA will apply for plan years beginning after December 31, 1979, and before the date of enactment.

Revenue Effect

It is estimated that this provision will have a negligible effect on budget receipts.

F. Continuation of Suspension of Effective Date for Certain NOL Carryover Rules (Sec. 808 of the bill and secs. 302 and 303 of the Code)

Present Law

The Tax Reform Act of 1976 substantially revised Code sections 382 and 383, relating to the carryover of corporate net operating losses and other corporate tax attributes following acquisitions or reorganizations.

Under present law, the 1976 Act revisions relating to acquisitions other than reorganizations are generally effective with respect to taxable years beginning after June 30, 1984. Those relating to reorganizations are effective with respect to a reorganization pursuant to a plan of reorganization adopted on or after January 1, 1984.

Reasons for Change

Because of problems with the 1976 Act revisions that have been brought to the attention of the committee, the committee concluded that the present effective dates for these revisions should be postponed until November 1, 1984, in order to allow time for further study and analysis.

Explanation of Provision

The provision modifies subsection (g) of section 806 of the Tax Reform Act of 1976 by substituting "November 1, 1984" for "January 1, 1984" in paragraphs (2) and (3) of that subsection and by substituting "October 31, 1984" for "June 30, 1984" in paragraph (2) of that subsection.

Thus, the provision postpones until November 1, 1984, the effective date for the 1976 Act revisions to Code sections 382 and 383, both for acquisitions and reorganizations. Accordingly, the 1976 Act revisions relating to acquisitions other than reorganizations will become generally effective with respect to taxable years beginning on or after November 1, 1984. Those relating to reorganizations will become effective with respect to a reorganization pursuant to a plan of reorganization adopted by either party on or after November 1, 1984.

Effective Date

The provision is effective as of January 1, 1984.

Revenue Effect

The provision is estimated to decrease budget receipts by less than $10 million annually.

G. Extension of the Special Tax Rules for the Payment-in-Kind Program (Sec. 806 of the bill and P.L. 98–4)

1. Description of the 1984 Payment-in-Kind Program

Overview

The Department of Agriculture ("USDA") announced a 1984 payment-in-kind ("PIK") program on August 9, 1983. The 1984 PIK program is a program for diverting from production land which otherwise would be used to produce wheat. Under the program, producers are provided a quantity of wheat as compensation for diverting acreage normally planted in that crop.

Present law limits to $50,000 the amount of payments USDA can make to a producer under crop acreage reduction programs. When the PIK programs were first announced in January 1983, USDA announced that the $50,000 limit applied only to cash payments—not to payments-in-kind. On November 1, 1983, the General Accounting Office issued a determination that the $50,000 limit applies to payments under all acreage reduction programs, whether made in cash or in kind.

USDA conducted a similar PIK program during the 1983 crop year for wheat, corn, grain sorghum, rice, and upland cotton. There are three main differences between the 1983 and 1984 programs: the 1984 program is limited to in-kind payments of wheat; in 1984 no payments will be made from Commodity Credit Corporation stocks—payments will be made only from commodities held under reserve loans, regular loans and "harvest-for-PIK" loans; and farmers will not be able to divert their whole crop acreage base in 1984, as was possible under the 1983 program.

PIK Program

General rules

Under the 1984 PIK program, farm producers generally may elect to divert from 10 to 20 percent of their wheat acreage base[1] from active crop production in exchange for a payment-in-kind equal to an established quantity of the wheat normally grown on the property. The established quantity is 75 percent of the farm's program yield.[2]

Property withdrawn from crop production under a 1984 PIK program is required to be devoted to conservation uses. Harvesting of any crop from land diverted under a 1984 PIK program generally is prohibited.

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[1] The term "wheat acreage base" means the average of the acreage planted and considered planted to wheat in 1982 and 1983.

[2] The term "farm program yield" means the yield of wheat from the farm property during an established historical reference period.

Executed PIK contracts are transferable by the farmer under certain circumstances; however, transfer of a PIK contract terminates the farmer's qualification for special tax treatment. Therefore, upon assignment of a PIK contract, the farmer recognizes income, which income is not treated as income derived from the active conduct of farming.

Payment procedures

Participating farmers are eligible for payment-in-kind on a date established for their locality which reflects the usual harvest dates of wheat in different regions. Farmers may receive payment on the established availability date, or they may elect to defer receipt of the payment for any period of time up to 5 months thereafter. The Federal Government bears all risk of loss and storage costs until payment is received by the farmer.

In-kind payments of wheat are to be paid only from wheat acquired by by the Federal Government through transactions the substance of which is forfeiture of collateral for regular and Farmer-owned Reserve ("FOR") price support loans made under price support programs administered by the Commodity Credit Corporation ("CCC").[3] In the case of payment from farm-stored FOR stocks, unlike the 1983 participants, farmers in the 1984 PIK program will not be eligible for additional storage costs beyond the normal 5 months allowed under the PIK program.

Producers with no outstanding loans must agree to harvest for PIK in order to receive a PIK payment, i.e., to grow their own PIK commodities on other land they farm. Price support loans will be made to farmers growing their own PIK. These loans will be secured by the commodities to be produced. Those producers with no outstanding loans who are unable to harvest for PIK will not receive a PIK payment.

The method of payment under the PIK program takes the form of a three-step transaction. First, the farmer repays outstanding loans (reserve loans, regular loans, or harvest-for-PIK loans) equal to the PIK payment.[4] At that time, the collateral for the repaid loans is released. Second, the Government repurchases the released commodities for an amount equal to the amount of the repaid loan (plus any accrued interest and charges paid by the farmer on repayment of the loan). Finally, the Government returns the commodities to the farmer as a payment-in-kind under the PIK contract.

Farmers may elect to have cooperatives receive payments otherwise due them provided the farmers have no outstanding CCC loans themselves. The payment procedures for cooperatives are generally the same as for individual farmers dealing directly with the Government. The cooperative's wheat loans must be used to satisfy the PIK requirements in the following order: reserve loans, regular loans and, finally, harvest-for-PIK loans. To meet the harvest-for-PIK requirement, the cooperative must obtain loans on eligible 1984 crop wheat to satisfy the designated PIK quantity in excess of outstanding reserve or regular loans. The cooperative will not be permitted to repay 1984 crop wheat loans unless a sufficient quantity of wheat remains under loan to satisfy PIK needs. PIK payments to cooperatives are to be held in pools separate from other crops held by the cooperatives.

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[3] The CCC is a Federally owned corporation which administers the farm price support program through grants of loans on crops eligible for support. The CCC establishes an annual loan rate per unit for each crop eligible for Government price supports. CCC then makes nonrecourse loans to farmers for their crops based upon this rate. If the market price for the crop rises above the loan rate, the farmer can redeem the crop, sell it, and retain any excess proceeds over the loan rate plus accrued interest and other charges. If the market price does not rise above the loan rate before the loan's due date, the farmer can forfeit the crop to the Government in full satisfaction of the loan.

[4] Producers with reserve loans will be required to use those loans before a regular loan can be used. If a producer has more than one reserve loan, the producer may choose which reserve loan to repay.

Cash Payment Acreage Reduction Programs

As under the 1983 PIK program, farmers are required to participate in the acreage limitation and paid diversion programs as a prerequisite of eligibility for the 1984 PIK program.

Under the 1984 wheat program, producers must limit 1984 wheat planted acreage to no more than 70 percent of the farm's wheat base (i.e., the acreage reduction requirement is 30 percent), and devote to conservation use an acreage of eligible cropland equal to 42.86 percent of the 1984 planted and PIK acreage.

Participation in the acreage reduction programs also entitles the farmer to price support loans and deficiency payments with respect to crops actually produced. The deficiency payments are equal to the excess of an established "target" price over the greater of the year's CCC loan value for the crop or the crop's national average market price. The 1984 target price for wheat is $4.45 per bushel and the national average loan rate is $3.30 per bushel.

2. Tax Treatment of Participants in Payment-in-Kind Programs

Present Law

Overview

The tax treatment of income from commodities produced by farmers is subject to numerous special rules under the Internal Revenue Code. Similarly, eligibility for a number of special income and estate tax provisions depends upon whether a taxpayer is (or a decedent was) either (1) engaged in the trade or business of farming, or (2) has income derived from the active conduct of the trade or business of farming.

Had the Payment-in-Kind Tax Treatment Act of 1983 (the "1983 Act")[5] not been enacted, participants in a 1983 PIK program could have been ineligible for many of the special income and estate tax provisions that are available to farmers since PIK commodities generally are not produced by the recipient in the active conduct of a farming operation. Even if such commodities are so produced, they have in effect been sold to the Government and returned to the PIK participant as consideration for withdrawal of farm land from production.

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[5] Public Law 98-4, March 11, 1983. H.R. 1296, a bill relating to the tax treatment of commodities received under the 1983 payment-in-kind program, was the subject of hearings on February 23, 1983 held by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means. The bill, as amended, was reported by the Committee on Ways and Means on March 2, 1983 (H. Rept. 98-14). The House approved the bill on March 8, 1983, by a record vote of 401 to 1 under suspension of the rules. The Senate approved the bill on March 8, 1983, with amendments. On March 9, 1983, the House concurred in the Senate's amendment with amendment. On March 10, 1983, the Senate concurred in the House amendment, clearing the measure for the President.

The 1983 Act modified the tax law to provide that participants in a 1983 PIK program generally are treated in a manner similar to that which would apply if they had actually grown the PIK commodities on the land withdrawn from production. Since the provisions of the 1983 Act apply only to land withdrawn from production during the 1983 crop year, payments received with respect to land withdrawn from production during the 1984 crop year generally will not be treated as income received from commodities produced by PIK participants in the active conduct of a farming operation.[6]

Income tax treatment of farmers

Timing of income

Generally, taxpayers engaged in farming may determine their income for Federal income tax purposes under either the cash or accrual method of accounting. However, corporations (other than certain "family owned" corporations, subchapter S corporations and certain corporations with annual gross receipts of less than $1 million) and certain partnerships must use the accrual method of accounting for farm operations (Code sec. 447).

A taxpayer may elect to consider amounts received as loans from the CCC as income in the year in which received (sec. 77). If the election is made, the taxpayer takes a basis in the crop equal to the amount included in income. If the commodity securing such loan is later forfeited, no income would be recognized at the time of such forfeiture to the extent of such basis.

Generally, a taxpayer may elect to defer the income from the discharge of indebtedness on qualified business indebtedness. The deferral of the income is achieved by excluding from income the amount of the debt discharged (sec. 108) with a corresponding reduction in the basis of certain assets (sec. 1017).

If a commodity is produced by a farmer, the farmer generally recognizes income only (1) when the commodity is sold or otherwise disposed of to a third party, or (2) when livestock, etc., to which a commodity is fed is sold or otherwise disposed of to a third party. Because the 1983 Act treats PIK commodities as produced by the PIK participants, these rules apply to such commodities. Had the 1983 Act not been enacted, however, under both the cash and accrual methods of accounting, farmers would have recognized income when the commodities were made available to them regardless of when actually received. The amount to be included in income would have been the fair market value of the commodity on the date the taxpayer recognized the income.

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[6] Winter wheat received as a PIK payment with regard to land withdrawn from production under a PIK program for the 1984 crop year remains eligible for the special treatment otherwise accorded only payments with respect to land withdrawn from production during the 1983 crop year. This rule applies only if the 1984 crop would have been planted before January 1, 1984, but for participation in a 1984 PIK program.

Other income tax provisions

Under the 1983 Act, for all purposes of the Internal Revenue Code, income from the sale or exchange of PIK commodities is treated as income from the trade or business of farming and the taxpayer is treated as using in the trade or business of farming any land diverted from production under a 1983 PIK program. Thus, income with respect to the sale or exchange of such commodities is treated as gross income from farming for purposes such as the following:

Estimated tax payments.—In general, a taxpayer is required to pay the tax shown on a tax return on the due date for filing the return (determined without regard to any extensions of time for filing the return). Corporations generally must pay at least 90 percent, and individuals 80 percent, of their current year's tax liability in quarterly estimated tax payments during the taxable year.

However, an individual whose estimated gross income from farming for the taxable year is at least two-thirds of his or her total estimated gross income from all sources for the taxable year (or whose gross income from farming shown on the preceding year's tax return is at least two-thirds of total gross income from all sources) must pay the estimated tax for a taxable year in full on or before January 15 of the succeeding taxable year.

Additionally, the requirement to make payments of estimated tax is considered met if, on or before March 1, the taxpayer files a return for the taxable year for which estimated tax payments are required and pays in full the amount of tax due (secs. 6015(g), 6073(b), and 6153(b)). Corresponding payment dates apply to taxable years beginning on a date other than January 1st. Further, the addition to the tax with respect to underpayment of estimated taxes will not be imposed if the estimated tax payments are at least 66-2/3 percent of the tax liability for the year (sec. 6654(d)).

Soil and water conservation expenditures.—Under present law, a taxpayer engaged in the business of farming may claim a current deduction for amounts which are paid or incurred during the taxable year for the purpose of soil or water conservation in respect of land used for farming, or for the prevention of erosion of land used for farming (sec. 175). The maximum amount that may be expensed in any taxable year may not exceed 25 percent of the taxpayer's gross income derived from farming during the taxable year.

The term "land used in farming" means land used (before or simultaneously with the expenditures described above) by the taxpayer or his or her tenant for the production of crops, foods, or other agriculture products or for the sustenance of livestock.

Expenditures by farmers for fertilizer, etc.—Under present law, a taxpayer engaged in the business of farming may elect to expense amounts that otherwise must be capitalized which are paid or incurred during the taxable year for materials to enrich, neutralize, or condition land used in farming, or for the application of such materials to the land (sec. 180). For this purpose, land is used in farming if it is used, either before or simultaneously with the expenditures described above, by the taxpayer or his or her tenant for the production of crops, fruits, or other agricultural products, or for the sustenance of livestock.

Expenditures by farmers for clearing land.—Under present law, a taxpayer engaged in the business of farming may elect to treat expenditures paid or incurred in a taxable year to clear land for the purpose of making such land suitable for use in farming as a currently deductible expense (sec. 182). However, this deduction for any taxable year may not exceed the lesser of $5,000 or 25 percent of the taxable income derived from farming during the taxable year (as defined).

Activities not engaged in for profit.—Under present law, if an individual or a Subchapter S corporation engages in an activity not for profit, no deduction (other than itemized deductions) attributable to such activity is allowable in excess of the income from that activity (sec. 183). Under those rules, an activity generally is presumed to be not engaged in for profit unless the activity generates a profit at least two years out of the most recent five-year period.

Gain from disposition of property used in farming or farm losses offsetting farm income.—Under section 1251, any person carrying on a trade or business of farming, other than any person utilizing the accrual method of accounting, is required to maintain an excess deductions account (EDA). Prior to taxable years beginning after December 31, 1975, any person having a farm net loss (the excess of farm deductions over gross income derived from farming), was obligated to add such amount to his EDA.

If, at the end of any taxable year, the EDA has a positive balance, then the amount of the EDA is reduced (1) for any farm net income (the excess of farming gross income over farm deductions for that taxable year), (2) for any amounts with respect to deductions which do not result in a tax reduction for the taxpayer, and (3) the amount realized from the sale, exchange, or involuntary conversion of farm recapture property. Farm recapture property includes depreciable personal property held for more than one year, certain cattle or horses, land held for more than one year, and unharvested crops growing on land which has been held for more than one year.

Limitation on deduction of investment interest.—In general, all interest paid or accrued during the taxable year on indebtedness is allowable as a deduction. However, if a taxpayer other than a corporation pays or accrues an amount of investment interest, then the otherwise allowable deduction with respect to that interest cannot exceed $10,000 ($5,000 in the case of a separate return by married individual), plus net investment income (sec. 163).

Imposition of tax on unrelated business income of charitable, etc. organizations.—A tax is imposed for each taxable year on the unrelated business taxable income of certain exempt organizations. The term "unrelated business taxable income" means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less deductions allowed which are directly connected with the carrying on of such trade or business. In general, all rents from real property are excluded from the computation of unrelated business taxable income.

Imposition of personal holding company tax.—A tax in addition to the regular corporate income tax is imposed on the undistributed personal holding company income of every personal holding company. This tax is equal to 50 percent of the undistributed personal holding company income. In general, a personal holding company is any corporation, other than certain specified types of corporations, at least 60 percent of the adjusted ordinary gross income of which is personal holding company income. In addition, more than 50 percent in value of the outstanding stock of a personal holding company must be owned, directly or indirectly, by 5 or fewer individuals during the last half of the taxable year. The term "personal holding company income" includes adjusted income from certain rents and royalties.

Employment tax treatment of farmers

A self-employment tax is imposed on net earnings from self-employment as defined by section 1402. Net earnings from self-employment means gross income derived by an individual from any trade or business, less allowable deductions attributable to such trade or business. Rentals from real estate including rentals paid in crop shares are excluded in determining net earnings from self-employment, unless such rentals are received in the course of a trade or business as a real estate dealer. However, this exemption does not apply to any income derived by a landlord if (1) the income is derived under an arrangement entered into between the landlord and another individual which provides for the landlord's material participation in the production or management of the production of the agricultural or horticultural commodities to be produced on the land by the individual, and (2) there is material participation by the landlord with respect to any such commodity. Thus, income which is received by a farmer who materially participates in the production of the income is treated as self-employment income. In addition, eligibility for the earned income tax credit is determined by reference to the earnings from self-employment.

Estate tax treatment of farmers

The estate tax current use valuation provision and installment payment provisions are available only in cases where property used in an active trade or business is included in the decedent's gross estate. The current use valuation provision requires that the decedent or a member of the decedent's family have materially participated for specified periods in the farming operation in which specially valued real property was used.

The current use valuation provision permits executors of decedents whose estates are comprised largely of real property used in the trade or business of farming to elect to value the real property for estate tax purposes based upon its current use rather than its full fair market value (sec. 2032A). The installment payment provision permits similarly situated estates to pay estate tax attributable to a closely held business in installments over up to 14 years (sec. 6166). In addition, certain amounts of the tax paid in installments under section 6166 accrue interest at a special 4-percent rate rather than at the higher deficiency rate otherwise applicable when payment of a tax is delayed (sec. 6601(j)).

The 1983 Act treats land withdrawn from production under a 1983 PIK program as used in the active trade or business of farming for purposes of these two estate tax provisions. In addition, material participation in the conservation use to which land withdrawn from production under a 1983 PIK program is put is treated as material participation for purposes of the current use valuation provision's requirement that such participation in the farming operation occur.

Income tax treatment of cooperatives

A cooperative is an organization, usually operating in corporate form, which is established and operated for the mutual benefit of its members and patrons by selling goods to them or purchasing products from them and returning to them any income in excess of costs. Unlike other corporations, a cooperative is allowed a deduction from its taxable income to the extent patronage source income is distributed to its members or patrons as a patronage dividend or in redemption of a non-qualified written notice of allocation. In addition, a cooperative may exclude from gross income amounts attributable to qualified per-unit retain allocations and redemptions of nonqualified per-unit retain certificates.

Patronage dividends (whether paid in cash, qualified written notices of allocation, in redemption of nonqualified written notices of allocation, or in other property other than nonqualified written notices of allocation) are includible in the income of a member or patron when paid or allocated. In general, an amount is a patronage dividend if it is payable out of patronage source income to all patrons of the cooperative equally on the basis of business done with or for patrons.[7] A per-unit retain allocation is, in general, an amount retained by the cooperative with respect to goods marketed by the cooperative for the patron.

Patronage source income is income directly related to business done with or for patrons. Thus, for example, investment income or income derived from the sale or exchange of capital assets is nonpatronage source income. A patron is any person doing business with the cooperative on a mutual basis.

Exempt farmers' cooperatives are allowed more beneficial tax treatment than nonexempt cooperatives in two respects. First, they are allowed a deduction for dividends paid from nonpatronage source income (including income from business done with or for the United States) to their patrons (not including the United States or its agencies). Second, they are allowed a deduction for amounts paid as dividends on their capital stock during the taxable year as long as the dividends do not exceed the greater of eight percent or the legal rate of interest in the State of incorporation.

A nonexempt cooperative is any cooperative other than an exempt farmers' cooperative. Nonexempt cooperatives cannot deduct dividends of nonpatronage source income, but they are not limited in the sources or amounts of their nonpatronage source income.

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[7] A patronage dividend must be payable (1) on the basis of the quantity or value of business done with or for the patron, (2) under an obligation to pay such amount which obligation existed when the cooperative received the amount, and (3) with reference to the net earnings of the cooperative from business done with or for its patrons.

Taxpayers eligible for special treatment

Only qualified taxpayers are eligible for the special treatment accorded by the 1983 Act. A qualified taxpayer is a taxpayer who is a producer (as defined in Department of Agriculture regulations) of agricultural commodities within the meaning of a 1983 PIK program and who diverts farm acreage from production and devotes such acreage to conservation uses in return for receiving a commodity under the program. Thus, a taxpayer who receives income from assignment of a PIK contract or an assignee of such a contract is not a qualified taxpayer under the Act.

Anti-speculation rule

The 1983 Act provides a special anti-speculation provision which generally limits application of the special income and estate tax treatment accorded interests in real property withdrawn from production under a PIK program and commodities received with respect to such interests to persons who owned the property on February 23, 1983.

Interests in real property acquired after February 23, 1983, and commodities received with respect to such interests, will remain eligible for the special income and estate tax treatment if —

(1) The interest is acquired by reason of death of the person who owned the interest on February 23, 1983;

(2) The interest is acquired by gift from the person who owned the interest on February 23, 1983;

(3) The interest is acquired from the person who owned it on February 23, 1983, by a person who is a member of the transferor's family; or

(4) The interest is acquired from a person who received the property in a transfer described in the above paragraphs, and, the current transfer also meets those requirements except for the fact that the current transferor did not own the interest on February 23, 1983.

Reasons for Change

The committee believes that farmers should not be discouraged from participating in the 1984 PIK program merely because of potentially adverse income and estate tax consequences. The committee is disturbed, however, over the extremely large payments received by some farmers under the 1983 PIK program. These large payments are especially disturbing in light of the General Accounting Office's determination on November 1, 1983, that payments under the Department of Agriculture's (USDA) acreage reduction programs in excess of $50,000 per farmer are not authorized under the applicable agriculture statutes.

All of these factors have led the committee to provide special tax treatment for 1984 PIK participants under modified rules. These new rules will provide tax treatment similar to that provided 1983 PIK participants only to the extent that payments received by a farmer under all USDA acreage reduction programs are determined to have been authorized under the Agriculture and Food Act of 1981. This limit on the special tax treatment applies to all PIK income with respect to which wheat would otherwise have been planted and harvested in 1984. Additionally, because the USDA has only announced a 1984 PIK program for wheat at the present time, the special tax rules provided by the committee amendment apply only with respect to that crop.

Explanation of Provisions

Overview

The committee amendment extends to participants in the 1984 PIK program for wheat the same favorable tax treatment accorded participants in the 1983 program, with one modification. Under the committee amendment, the amount of PIK payments eligible for special income tax treatment is limited to the maximum authorized Federal acreage reduction program payments, reduced by any cash payments received by the producer under USDA acreage reduction programs. The term producer is to have the same meaning as under USDA regulations governing acreage reduction programs, as those regulations are in existance on the date of the amendment's enactment. This limit is to apply to payments received (and land withdrawn from production) with respect to crops that would have been planted and harvested during 1984 but for participation in the PIK program. Therefore, the limit does not apply with respect to winter wheat that would otherwise have been planted in 1983 but harvested during 1984 since that wheat is provided for under the 1983 Act.

Income tax treatment of farmers

Timing of income.—The committee amendment provides that a qualified taxpayer will not be treated as having realized income when he or she receives, or has the right to receive, a commodity under a 1984 payment-in-kind program for wheat. Thus, both accrual and cash basis taxpayers can defer the recognition of income that would otherwise be recognized in the year the commodities are received, until the year the commodities are sold, exchanged, or otherwise disposed of.

For purposes of determining the gain or loss from the sale, exchange or other disposition of the commodity, the unadjusted basis of the commodity will be zero. The commodity will be treated as produced by the taxpayer for purposes of determining the character of the gain (ordinary income or capital gain) from the sale of the commodity.

In cases where a CCC loan is involved, the committee understands that the payment-in-kind of a commodity to a taxpayer is to be achieved by a 3-step process: the repayment by the taxpayer of the loan from the CCC, the purchase by the CCC of the commodity securing the loan at the redemption price of the loan, followed by the receipt of the commodity by the taxpayer as a payment-in-kind. In any such case, the taxpayer who receives the commodity as payment-in-kind (in the third step of this 3-step process) will be entitled to the same tax treatment on such receipt as a taxpayer who receives a payment-in-kind where a CCC loan is not involved.

If the taxpayer has made an election under section 77 to recognize income in the year the CCC loan proceeds were received, the repayment of the loan and the purchase by the CCC of the commodity (the first and second steps of the 3-step process) will be treated by the taxpayer as a purchase of the commodity at an amount equal to the then outstanding balance of the loan (the original amount of the loan plus interest and storage costs) followed by a sale to the CCC at the same amount. Thus, the taxpayer will be allowed a deduction for the accrued interest and storage costs and must recognize in income an equal amount which represents the difference between then outstanding balance of the loan and the taxpayer's basis.

In the case of a taxpayer who has not made an election under section 77, the repayment of the CCC loan and the purchase by the CCC of the commodity securing the loan (the first and second steps of the 3-step process) will be treated by the taxpayer as a repayment of the then outstanding balance of the loan (the original amount of the loan plus interest and storage costs) followed by a sale to the CCC at the same amount. Thus, the taxpayer will be allowed a deduction for the accrued interest and storage costs and will recognize in income an amount equal to the then outstanding balance of the loan.

Other income tax provisions.—Under the bill, for all purposes of the Internal Revenue Code, income from the sale or exchange of PIK commodities will be treated as income from the trade or business of farming and the taxpayer will be treated as using in the trade or business of farming any land diverted from production under the 1984 PIK program for wheat. Thus, income with respect to the sale or exchange of wheat received under the 1984 PIK program will be treated as gross income from farming for all purposes of the Code, including (but not limited to):

(1) payments of estimated tax;

(2) method of accounting by corporations engaged in farming;

(3) expensing of certain soil and water conservation expenditures;

(4) expensing of certain expenditures by farmers for fertilizer;

(5) expensing of certain expenditures by farmers for clearing land;

(6) deductibility of expenses attributable to activities not engaged in for profit;

(7) gain from disposition of property used in farming or farm losses offsetting farm income;

(8) limitation on deduction of investment interest;

(9) tax on unrelated business income of charitable, etc., organizations; and

(10) tax on personal holding companies.

Employment tax treatment of farmers

Under the bill, income from the sale or exchange of wheat received in the 1984 PIK program will be subject to the tax on net earnings from self-employment for any individual who materially participates in the diversion and devotion to conservation uses of the PIK program.

Estate tax treatment of farmers

Current use valuation (Code sec. 2032A).—The bill provides that real property removed from production under a 1984 PIK program will be treated as used in an active farming (i.e., qualified) use for purposes of the estate tax current use valuation provision.

The bill also provides that, in the case of property removed from production under the 1984 wheat PIK program, the material participation requirements of the current use valuation provision will be satisfied if an individual otherwise required to materially participate in the active farming use of specially valued real property materially participates in the conservation use to which the property is devoted.

Installment payment of estate tax (Code sec. 6166).—The bill provides that real property withdrawn from production under a 1984 PIK program that was used in the conduct of an active trade or business before being so withdrawn will be treated as used in such trade or business. Therefore, in determining whether at least 35 percent of the value of an individual's adjusted gross estate consists of the value of an interest in a closely held business, real property withdrawn from production under the 1984 PIK program will be treated as used in the closely held business. Similarly, such property will be treated as used in an active trade or business in determining whether an individual's interest in such a business is an interest in a closely held business within the meaning of the installment payment provision.

In adopting these rules, the committee does not intend generally to change the present law rules governing the type of business which constitutes an active trade or business under the installment payment provision. Instead, the provisions of the committee amendment merely treat real property withdrawn from production under the 1984 PIK program which is part of a business that otherwise qualifies for the installment payment provision as continuing to be used in such business.

No inference as to diversion programs other than programs involving a payment-in-kind.—These estate tax provisions of the bill apply only to real property withdrawn from production under the 1984 PIK program, i.e., a program under which a payment of commodities is made. The committee is aware that the Federal Government also conducts other farm real property diversion programs. The committee understands that, at the present time, these other programs either provide for cash payments in exchange for withdrawal of the property from production or require withdrawal of the property from production as a condition of eligibility for price support payments.

The committee intends that no inference be drawn that real property diverted from production under other Federal Government farmland removal programs is, or is not, used in the active business of farming from the fact that the bill only applies to real property withdrawn from production under the 1984 PIK program.

Income tax treatment of cooperatives

As was true under the 1983 PIK tax rules, PIK wheat received by a cooperative on behalf of a member or patron who is a qualified taxpayer is treated as (1) produced by that member or patron in his or her business of farming and (2) received by the cooperative from the member or patron.

Taxpayers eligible for special tax treatment

As under the 1983 PIK rules, only qualified taxpayers are eligible for the special tax treatment provided by the committee amendment. A qualified taxpayer is any taxpayer who meets the following two requirements. First, the taxpayer must be a producer (as defined in the Department of Agriculture regulations) of wheat. Second, the taxpayer must divert farm acreage from production and devote such acreage to conservation uses in return for receiving any commodity under the 1983 payment-in-kind programs.

The committee understands that, for purposes of the requirement that a person divert acreage from production and devote such acreage to conservation uses, the term "person" includes not only the person who actually diverts the acreage from production (such as a land owner) but also any other producer who receives a payment-in-kind with respect to such acreage (such as a sharecropper).

An assignee of a PIK contract or a producer receiving a payment for assignment of such a contract is not a qualified taxpayer.

Anti-speculation rule

To prevent speculation in farm land as a result of a PIK program, the bill retains for the 1984 PIK program the special anti-speculation rule that generally limits application of the special income and estate tax treatment accorded interests in property withdrawn from production to persons who owned the withdrawn property on February 23, 1983. Certain property interests acquired by reason of death, gift, or otherwise from a family member continue to qualify for the special treatment after the interests are transferred.

Determination of maximum amount of authorized payments and limitation of special tax treatment

As stated in the explanation of the PIK program, USDA in a published regulation and GAO in a General Counsel's opinion have reached conflicting results on the maximum authorized payments per producer under Federal acreage reduction programs. The special tax provisions provided by the bill for the 1984 wheat program apply only to legally authorized payments. To facilitate a determination of whether acreage reduction payments in excess of $50,000 generally are authorized by law if the excess amounts are paid in kind rather than in cash, the bill directs the Comptroller General to seek a declaratory judgment in the U.S. District Court for the District of Columbia. This proceeding is to be commenced within 60 days of the date of enactment of the bill.

If the court determines that the $50,000 limit on acreage reduction payments applies both to cash and in kind payments, producers will not be eligible for the special income tax treatment provided for the 1984 wheat program by the amendment to the extent that they receive acreage reduction payments in excess of $50,000. In such cases, PIK payments eligible for the special tax treatment will be equal to the excess of the maximum authorized acreage reduction payment over the amount of such cash payments received by the producer. For purposes of this determination, the value of in kind commodities will be equal to their fair market value (based upon the value of like commodities in the locality of the recipient's farm) on the date of receipt (or constructive receipt).

The bill also provides that the income tax treatment of cooperatives is not to be affected by any determination in the declaratory judgment proceeding (i.e., as a result of disqualification of any PIK payment accepted by the cooperative on behalf of a member or patron). Also, availability of the special estate tax provisions (secs. 2032A and 6166) is not to be affected.

The special tax treatment previously accorded participants in the 1983 PIK program (including that accorded producers of winter wheat that would be planted in 1983 and harvested in 1984 but for PIK participation) is not to be affected by any court decision as to whether payments over $50,000 made in the 1983 program were authorized by applicable agriculture acts. This is true even though the holding of the court may be that the payments were not authorized by the applicable agriculture acts.

Effective Date

The income tax provisions of the bill apply to wheat payments received in the 1984 PIK program; the estate tax amendments apply to land withdrawn from production in that program.

Revenue Effect

Based upon information provided by the Department of Agriculture, the bill is estimated to reduce budget receipts by $7 million in fiscal year 1984, and by $8 million in fiscal year 1985. Budget receipts are estimated to increase by $15 million in fiscal year 1986 as a result of the bill.

H. Effective Date for 1978 Revenue Act Rules on Taxation of Unemployment Compensation Benefits (Sec. 807 of the bill)

Present Law

Prior to the Revenue Act of 1978, unemployment compensation paid under most government programs was excludable from gross income under a series of Internal Revenue Service rulings dating from 1938.[1] Section 112 of the Revenue Act of 1978 made includible a portion of unemployment compensation benefits paid pursuant to government programs to taxpayers who have substantial income during the year (Code sec. 85).

Under the 1978 legislation, gross income included the lesser of the amount of unemployment compensation or one-half of the excess of (1) the sum of the taxpayer's adjusted gross income, all unemployment compensation paid pursuant to government programs, and all disability income of the type eligible for exclusion from income under Code section 105(d) (now repealed), over (2) the taxpayer's base amount. The Economic Recovery Tax Act of 1981 (sec. 103(c)(1)) modified the includible amount by adding to the items in (1) above the amount allowed under the deduction for two-earner married couples. (Any social security benefits otherwise included in adjusted gross income under the Social Security Amendments of 1983 are not included in adjusted gross income for purposes of determining taxable unemployment compensation.)[2]

The Revenue Act of 1978 provides that the unemployment compensation taxation provisions apply to payments of unemployment compensation made after 1978, in taxable years ending after 1978, Thus, benefits paid in 1979 and later years may be subject to income tax even if attributable to periods of unemployment before 1979.

Reasons for Change

The committee believes that it is inappropriate to include in income any unemployment compensation benefits attributable to weeks of unemployment beginning before December 1, 1978, since such benefits may be for periods of unemployment occurring well before the unemployment compensation taxation provisions were enacted. Accordingly, the provision amends the Revenue Act of 1978 so that the unemployment compensation taxation provisions apply to payments of unemployment compensation benefits made after 1978, except payments for weeks of unemployment ending before December 1, 1978.

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[1] See I.T. 3230, 1938-2 C.B. 136 (payments by a State agency out of funds received from the Federal Unemployment Trust Fund); Rev. Rul. 55-652, 1955-2 C.B. 21 (unemployment compensation payments to Federal employees by State or Federal agencies); Rev. Rul. 70-280, 1970-1 C.B. 13 (payments by a State agency out of funds received from the Federal Unemployment Trust Fund); Rev. Rul. 73-154, 1973-1 C.B. 40 (unemployment compensation payments made under the Unemployment Compensation Act of 1971); Rev. Rul. 76-63, 1976-1 C.B. 14 (unemployment compensation benefits paid under the Emergency Jobs and Unemployment Assistance Act of 1974 and the Emergency Unemployment Compensation Act of 1974); Rev. Rul. 76-144, 1976-1 C.B. 17 (payments made under the Disaster Relief Act of 1974); and Rev. Rul. 76-229, 1976-1 C.B. 19 (trade readjustment allowances paid under the Trade Act of 1974).

[2] Social Security Amendments of 1983 (the Amendments), sec. 121(f)(1). The Amendments also repeal former Code sec. 105(d) and delete the reference to Code sec. 105(d) disability income in Code sec. 85 (Amendments, secs. 122(b) and 122(c)(2)).

Explanation of Provision

The provision amends the Revenue Act of 1978 to provide that the provisions of that Act making includible in gross income certain amounts of unemployment compensation benefits apply to payments of unemployment compensation made after 1978, except payments for weeks of unemployment ending before December 1, 1978.

The provision permits taxpayers who are entitled as a result of the amendment made by the provision to a credit of any overpayment or refund, but for the operation of the statute of limitations or another rule of law (including res judicata), to obtain the credit or refund by filing a claim for it before the close of the one-year period beginning on the date of enactment.

Effective Date

The provision is effective on enactment.

Revenue Effect

The amendment made by the provision is estimated to result in refunds or credits of less than $1 million.

I. Tax Refunds Relating to Traveling Expenses Incurred in 1970-74 for Employment at North Dakota Anti-Ballistic Missile Site (Sec. 808 of the bill and sec. 162 of the Code)

Present Law

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business (Code sec. 162). Traveling expenses which meet these general requirements are deductible if incurred while away from home in the pursuit of a trade or business. For these purposes, traveling expenses include transportation fares as well as amounts expended for meals and lodging, other than amounts which are lavish or extravagant under the circumstances (sec. 162(a)(2); Treas. Reg. sec. 1.162-2(a)). No deduction is allowed for personal, living, or family expenses, including the cost of commuting to and from work.

Traveling expenses are considered to be incurred while away from home in several different situations. One such situation is when the traveling expenses are incurred in connection with temporary employment and the taxpayer has a regular or principal place of business (or, in its absence, a regular place of abode) away from which the temporary employment takes place. The term temporary for this purpose generally is defined by the Internal Revenue Service and the majority of courts to mean employment which can reasonably be expected to last only for a short period of time. By contrast, traveling expenses incurred in connection with employment which is considered to be of indefinite or indeterminate duration generally are not deductible. On numerous occasions, the courts have considered the issue of whether a particular taxpayer's employment is temporary or indefinite in nature.[1]

In a 1979 case, *Frederick* v. *United States*,[2] the U.S. Court of Appeals for the Eighth Circuit upheld a district court ruling that a taxpayer's employment as a carpenter at an antiballistic missile project in Nekoma, North Dakota, during the years 1970 through 1973, was temporary and, therefore, that the taxpayer's associated transportation expenses were deductible. The District Court had reasoned that because of the seasonal nature of the employment and numerous lay-offs during construction, the taxpayer had reasonably expected to be employed on the project for a temporary period only. The Internal Revenue Service has stated that it will not follow the *Frederick* decision outside the Eighth Circuit.[3]

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[1] See, e.g., *Peurifoy* v. *Comm'r*, 358 U.S. 59 (1958); *Kasun* v. *U.S.* 671 F.2d 1059 (7th Cir. 1982); *Clark* v. *Comm'r*, 46 T.C.M. 964 (1983); *Blankenship* v. *Comm'r*, 39 T.C.M. 91 (1979). See also Rev. Rul. 83-82, 1983-1 C.B. 45; Rev. Rul. 60-189, 1960-1 C.B. 60.

[2] 79-2 U.S.T.C. para. 9529 (8th Cir. 1979), *aff'g* 78-2 U.S.T.C. para. 9774 (N.D. 1978).

[3] See Rev. Rul. 80-333, 1980-2 C.B. 60.

Reasons for Change

As described above, in the *Frederick* case the Eighth Circuit upheld a trial court's finding that the employment of a taxpayer-carpenter involved in that case at the Nekoma, North Dakota antiballistic missile site was temporary, and that the taxpayer could deduct transportation expenses associated with his employment. The committee understands that other employees working at the same missile site claimed deductions on their returns for traveling expenses paid between 1970 to 1974, but were not parties to the litigation and are now barred by the statute of limitations from filing refund claims on the basis of the 1979 court decision. The committee believes that, in light of the unusual circumstances of employment during the 1970-1974 construction period at the Nekoma, North Dakota missile site, other employees who worked on the construction project should be granted the same tax treatment with respect to traveling expenses as the taxpayer-carpenter in the court case. The provision is addressed to these special circumstances and is not intended to serve as precedent for resolving issues as to whether instances of employment other than that specifically addressed by the provision are temporary for purposes of the business expense deduction.

Explanation of Provision

The provision provides a statutory rule for the income tax treatment of certain transportation and traveling expenses incurred in connection with employment at the antiballistic missile project near Nekoma, North Dakota.

Under the provision, employment at the Nekoma, North Dakota antiballistic missile project is treated as temporary, for purposes of the business deduction rules, with respect to transportation and traveling expenses meeting three requirements. These requirements are: (1) the expenses are otherwise deductible as a business expense under Code section 162(a); (2) the expenses were paid or incurred after 1969 and before 1975; and (3) the expenses were claimed on a tax return filed for any taxable year which includes any portion of the period described in (2). If these requirements are satisfied, traveling and transportation expenses incurred in connection with employment at the Nekoma, North Dakota antiballistic missile project are deductible under the business deduction rule permitting the deduction of certain expenses incurred in connection with temporary employment.

In addition, the amendment permits taxpayers who would be entitled as a result of the provision to a credit of any overpayment or refund, but for the operation of the statute of limitations or another rule of law (including res judicata), to obtain the credit or refund by filing a claim for it within one year after the date of enactment.

Effective Date

The provision applies to taxable years ending after 1969, with respect to expenses paid or incurred after 1969 and before 1975.

Revenue Effect

The amendment made by the provision is estimated to result in credits or refunds of less than $1 million.

J. Nonimposition of Interest and Penalties on Tax Liability With Respect to Home Won as Prize and Designed for Handicapped Foster Child of the Taxpayer (Sec. 809 of the bill)

Present Law

Under present law, gross income generally includes amounts received as prizes, such as cash or property won in a lottery, sweepstakes, or other contest (Code sec. 74(a)).

Reasons for Change

The committee has become aware of a situation in which the mother of a handicapped foster child won a $75,000 house in a contest involving more than one million entries. The developer custom-built the house to meet the needs of the 13-year-old boy, who has had kidney and heart surgery and is paralyzed. The taxpayer was unable to obtain a mortgage on the house to timely pay the entire tax liability due with respect to inclusion of the fair market value of the house in her gross income, because of her low salary as a school computer operator, and has been unable to work out a schedule for installment payment of the tax liability which is acceptable to the IRS. As a result, a lien has been placed on the house, and she may be forced to sell it.

The committee also understands that a donor has offered, as an act of private charity, to pay the tax liability resulting from inclusion of the house in gross income, but not any interest or penalties imposed for prior nonpayment of that liability (understood to amount to about $20,000). Under these circumstances, the committee believes that it would not be appropriate to impose interest and penalties with respect to the tax liability to be paid by the charitable-minded donor so that the handicapped child may continue to live in the house which was specially designed to meet his needs.

Explanation of Provision

Under the provision, no interest, penalty, or similar addition to tax is payable on the amount of Federal income tax (computed without regard to such amounts) attributable to receipt of a residence won as a prize, where certain conditions apply, but only if such tax liability (as so computed) is paid within one year after the date of enactment of the provision. The provision only applies to a residence which (1) was won by the taxpayer in a local radio contest; (2) was specially designed to meet the needs of a handicapped foster child of the taxpayer; (3) is the principal residence (within the meaning of sec. 1034) of the taxpayer; and (4) had a lien placed on it by the Internal Revenue Service on May 24, 1983, after an Internal Revenue Service supervisor had overruled two payment schedules negotiated with the taxpayer for the payment of taxes, interest, and penalties on income attributable to such residence for the taxpayer's 1980 taxable year.

Effective Date

The provision is effective on enactment.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

K. Amendments With Respect to the Tax Treatment of Regulated Investment Companies (Sec. 810 of the bill and secs. 851-52 of the Code)

Present Law

General rules

Regulated investment companies.—Under present law, a regulated investment company (RIC) is treated, in essence, as a conduit for tax purposes. If a corporation qualifies as a RIC, it is allowed a deduction for dividends paid (or deemed paid) to its shareholders. Thus, a corporate level tax on such earnings is not payable.

In order for a corporation to be a RIC, it must meet several requirements.

First, a RIC must be a domestic corporation which (1) at all times during the taxable year is registered under the Investment Company Act of 1940, as amended, either as a management company or as a unit investment trust, or (2) which is a common trust fund which meets certain requirements.[1]

Second, the corporation must elect RIC status for the taxable year (or has made such an election for a previous taxable year).

Third, the corporation must not be a personal holding company for the taxable year.

Fourth, the corporation must meet certain gross income and investment requirements. In general, at least 90 percent of the corporation's gross income must be derived from dividends, interest, certain payments with respect to securities loans, and gains from the sale or other disposition of stock or securities. In addition, less than 30 percent of its gross income can be derived from the sale or other disposition of stock or securities held for less than three months. At the close of any quarter, at least 50 percent of its total assets must be represented by cash, cash items, government securities, government securities of other RICs, and certain other securities. Not more than 25 percent of the value of the total assets of the corporation can be invested in securities (other than government securities or securities of other RICs) of any one issuer, or of two or more issuers controlled by the taxpayer and determined to be engaged in the same, similar, or a related trade or business.

Fifth, a RIC must distribute at least 90 percent of its investment company taxable income for the taxable year (determined, in general, without regard to the dividends paid deduction), and 90 percent of the amount of its tax exempt interest income over the deductions allocable to such exemption (and disallowed as deductions for that reason).

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[1] These requirements are that the corporation be a common trust fund or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 from the definition of "investment company" and not included in the definition of common trust fund by Code section 584(a).

As indicated above, if a corporation qualifies as a RIC, it is allowed a deduction for distributions paid to its shareholders. The RIC shareholder is taxed on the amount of dividends received or deemed received. Special rules apply with respect to capital gains income and exempt-interest dividends.

If any of the requirements for RIC status are not met for the taxable year, then the RIC is taxed as a corporation for that taxable year and is not entitled to the special RIC deduction for dividends paid.

Personal holding companies.—Personal holding companies are subject to a special 50 percent tax on their undistributed personal holding company income. In general, a personal holding company is any corporation, other than certain types of corporations,[2] at least 60 percent of the adjusted ordinary gross income which is dividends, interest, rents, royalties, or other types of passive income. In addition, at any time during the last half of the taxable year, more than 50 percent of the value of the corporation's outstanding stock must be owned (directly or indirectly) by or for not more than five individuals.[3] Certain attribution rules apply to determine the number of shareholders in a PHC.

Accounting for short-term government obligations

In the case of any short-term obligation of the United States, a state, or any possession of the United States, or any political subdivision of the foregoing, or the District of Columbia, issued at a discount and redeemable at maturity without interest, the amount of the issue discount is deemed to accrue at the earlier of the date the obligation is paid at maturity, or the date the obligation is sold or otherwise disposed of. For this purpose, an obligation is a short-term obligation if it has a fixed maturity date not exceeding one year from the date of issue. Thus, with respect to such obligations, accrual basis taxpayers are not taxable on the discount until the obligation matures.

Reasons for Change

The recent enactment of the Subchapter S Revision Act of 1982 allows a personal holding company (PHC) to elect subchapter S status and thereby have its income taxed directly to the shareholders without the imposition of a corporate tax. The subcommittee believes that a PHC should also be able to elect regulated investment company (RIC) status so that its earnings may be taxed to the shareholders rather than the corporation.

The subcommittee is concerned that operating corporations would accumulate earnings and profits as a regular corporation, sell its operating assets, invest the profits in passive investment assets, and then elect one of the types of entities that is treated as a conduit for tax purposes. In such a case, the shareholders, in essense, are able to change their holdings from operating assets into investment assets without distributing the earnings from the operating activities. For this reason, the Subchapter S Revision Act of 1982 limited the use of subchapter S by corporations with both passive income and undistributed corporate earnings accumulated when it was not an S corporation. Similarly, the Tax Reform Act of 1976 limited the use of the corporate merger rules involving investment companies. Consistent with the concepts of those pieces of legislation, the subcommittee also believes that a corporation with earnings which accumulate while the corporation did not have RIC status have not been taxed to their shareholders should not be able to elect RIC status and thereby exempt themselves from corporate tax in the absence of a shareholder tax on these prior earnings.

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[2] The corporations excluded from the definition of personal holding company include tax-exempt corporations, banks, savings and loans, life insurance companies, certain lending or finance companies, certain foreign held corporations, and small business investment companies.

[3] For this purpose, a trust created or organized in the United States and forming part of a qualified stock bonus, pension, or profit sharing plan and certain private foundations are included in the definition of individual.

Finally, the committee believes that a RIC should be able to account for issue discount on short-term government obligations on the accrual basis. This method is consistent with the method used by RICs in accounting for, and computing distributions to, shareholders.

Explanation of Provision

Qualification of a RIC

The bill repeals the prohibition of present law which denies eligibility for RIC status to a personal holding company (PHC). However, the undistributed investment company taxable income of any RIC which is a PHC will be subject to tax at the highest corporate rate (presently 46 percent).

The bill also provides that no corporation may qualify for treatment as a RIC, for any taxable year, unless (1) the RIC provisions applied to the company for all taxable years ending after November 8, 1983, or (2) at the close of the taxable year, the company had no accumulated earnings and profits from a taxable year in which it was not subject to the RIC provision. Thus, in the future, any corporation with accumulated earnings and profits attributable to a non-RIC year will be ineligible to elect RIC status without a distribution of those earnings.

The bill provides rules to allow a company to be eligible to be treated as a RIC, notwithstanding the new E&P rule, for any taxable year subsequent to a taxable year with respect to which it is determined that the RIC qualification requirements were not met. Under these rules, a corporation may requalify as a RIC if the corporation, within 90 days after a determination[4] is made, distributes property in an amount equal to the accumulated earnings and profits (as of the determination date) attributable to the non-RIC year,[5] less any interest charge. The distribution must be designated as being taken into account for the disqualified year and will not be deductible in computing the taxable income of the company. The interest charge is computed for the period from the filing date for the disqualified year to the determination date on an amount equal to 50 percent, (i.e., the highest rate of tax applicable to individuals) of the E&P for the non-RIC year. The period of limitation on assessment and collection of the interest will be determined as if the interest arose from a tax imposed in the year the determination is made. These procedures will not apply in the case of fraud.

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[4] The term "determination" includes a final court decision, a closing agreement, or other agreement between the Internal Revenue Service and the company. The committee expects that the Internal Revenue Serice will establish a procedure to determine the amount of the company's earnings and profits attributable to non-RIC years by the time of the determination date and to extend the 90-day period if the company and the Internal Revenue Service cannot agree on such earnings and profits until such time as there is a resolution of that amount by agreement among the parties or by a final court decision. Moreover, where a company determines that it did not qualify as a RIC for a year and determines its tax liability and distributed its earnings and profits accordingly, but it is later determined that the company had additional earnings and profits from that non-RIC year, the committee expects that the Internal Revenue Service will make determination in order that these subsequently determined earnings and profits may be timely distributed.

[5] The accumulated earnings and profits from a non-RIC year is the earnings and porofits from the non-RIC years reduced by a deficit in earnings and profits subsequent to the non-RIC year and before the determination date.

Accounting for short-term government obligations

The bill provides that the issue discount accruing with respect to any short-term government obligation will be taxable to the RIC as it accrues, if the company so elects in a manner prescribed by the Internal Revenue Service. This provision permits RICs to conform the income tax accounting rules for short-term government obligations with the book accounting methods.

Effective Dates

The new RIC qualification rules will apply to taxable years beginning after December 31, 1982. In the case of any corporation which was a RIC for any taxable year ending before November 8, 1983, earnings and profits from any taxable year ending before that date shall be disregarded in applying the new E&P requirement. Also, in the case of any corporation beginning business in 1983, E&P from that initial year shall be disregarded in applying this rule.

The accounting rule will apply to taxable years beginning after December 31, 1978.

Revenue Effect

The provisions of the bill are estimated to have a negligible effect on budget receipts.

L. Federal Unemployment Tax Act Treatment of Tip Income (Sec. 806 of the Bill and Sec. 3306 of the Code)

Present Law

The Federal Unemployment Tax Act (FUTA) imposes a minimum, net Federal payroll tax of 0.8 percent on the first $7,000 in wages paid annually to each employee. Under current law, tip income is considered wages for purposes of FUTA only to the extent that:

(1) it is paid directly to the employee by the patron (tips charged on a credit card are not considered to have been paid directly to the employee); and

(2) the tip income is reported by the employee to the employer in writing; and

(3) the tip income is used by the employer to satisfy the minimum wage rate applicable to the employee under the Fair Labor Standards Act.

Reasons for Change

Generally, State unemployment insurance laws provide unemployment insurance coverage only for employment covered by FUTA. If wages are subject to FUTA, they are generally subject to State unemployment insurance tax and can be used by the employee as qualifying wages for purposes of determining eligibility for unemployment benefits and the amount and duration of such benefits.

Under current law, only a portion of tip income is considered wages subject to the FUTA tax. Under most States' unemployment insurance laws, tip income excluded from FUTA tax cannot be used by the employee to establish eligibility for unemployment benefits. By expanding FUTA coverage to all reported tip income, including charged tips, it is anticipated that State unemployment insurance laws will be amended to include all reported tip income as taxable wages and qualifying wages. Such a change in State laws will improve unemployment insurance protection for tipped employees.

Explanation of Provision

The bill provides that all tip income, including charged tips, reported by an employee to his employer will be considered wages for purposes of FUTA.

Effective Date

The provision applies to tip income received after December 31, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $16 million in 1985, $26 million in 1986, and $28 million in 1987.

M. Qualification of Certain Holding Company Stock for Installment Payment of Estate Tax (sec. 807 of the bill and sec. 6166 of the Code)

Present Law

Qualification for installment payments

Estate tax attributable to certain interests in closely held businesses may be paid in installments over up to 14 years (interest only for 4 years followed by up to 10 annual installments of principal and interest) (Code sec. 6166). A special 4-percent interest rate is provided for the first $345,800 of tax (less the decedent's unified credit) (sec. 6601).

An estate is eligible for the installment payment provision if the value of the business interest equals at least 35 percent of the value of the adjusted gross estate. An interest in a corporation qualifies for the installment payment provision if (1) the corporation has 15 or fewer shareholders or (2) the decedent owned 20 percent or more of the voting stock of the corporation.

Generally, only directly owned stock in a corporation actively engaged in a business operation is considered for purposes of the 35-percent and 20-percent tests. A special rule permits attribution to a decedent of stock owned by certain family members; however, if this attribution provision is elected, the 5-year deferral of principal and the special 4-percent interest rate are not available.

Acceleration of unpaid installments

Unpaid installments of tax are accelerated in certain circumstances. First, if cumulative dispositions and withdrawals from the business equal 50 percent or more of the decedent's interest, all unpaid installments are accelerated. Redemptions of stock under section 303 (relating to income tax treatment of certain redemptions for payment of estate taxes) are not considered withdrawals for purposes of the acceleration rules if an amount equal to the redemption proceeds is used to pay Federal estate taxes on or before the due date of the first installment that becomes due after the date of the redemption.

Second, all unpaid installments are accelerated if an estate has undistributed net income (UNI) in any year after the first installment is due unless the executor pays an amount equal to the UNI. Third, all unpaid installments are accelerated if payment of any installment is not made within 6 months after the due date of that installment.

Reasons for Change

The committee believes it is appropriate to permit certain holding companies to be pierced to determine whether an individual owned an interest in a closely held business qualifying for the estate tax installment payment provision. However, because of the complexity in applying a "look through" rule to multiple tiers of corporations, the committee decided to limit the provision to cases where at least 80 percent of the value of the assets of the holding company consist of stock in a first-tier active business. Finally, the committee determined that the special restrictions that apply to cases where stock owned by family members is attributed to a decedent also should apply in the case of active business interests owned indirectly through holding companies.

Explanation of Provision

Qualification for installment payments

The bill permits an executor to elect to treat stock in certain qualified holding companies as stock in an active business for certain purposes under the estate tax installment payment provision. This rule applies only to stock in holding companies at least 80 percent of the value of which consists of non-readily tradeable stock in a first-tier corporation carrying on an active business. Additionally, only the portion of the value of the holding company that is attributable to stock in the first-tier corporation carrying on an active business may be considered; therefore, the value of cash or other holding company investment assets is disregarded.

Under the bill, the value of voting stock owned by a decedent in qualified holding companies may be considered in determining whether the decedent owned 20 percent or more of the voting stock in a corporation carrying on a trade or business (sec. 6166(b)(1)(C)(i)). The value of such voting stock may also be considered in determining whether at least 35 percent of the value of the decedent's adjusted gross estate is attributable to the value of an interest in a closely held business.

Nonvoting stock in a qualified holding company may be considered for purposes of the 35-percent test. On the other hand, nonvoting holding company stock may not be considered in determining whether the decedent owned an interest in a closely held business (i.e., satisfied the 20-percent test). For purposes of the 35-percent test, the value of the holding company stock that is treated as though it were stock of an active business corporation is the value of such for Federal estate tax purposes, unaffected by the treatment of such stock as stock of the second corporation.

If an executor elects to include the value of qualified holding company stock under section 6166, the special 4-percent interest rate and the 5-year deferral of payments of principal are not available.

Acceleration of unpaid installments

Special rules apply under the acceleration provisions of section 6166(g) if the executor makes an election under this provision of the bill. First, any disposition of holding company stock or withdrawal of money or other property from the holding company is treated as a disposition or withdrawal from the closely held business qualifying for installment payments. In addition, if the qualified holding company disposes of any of its active business stock or withdraws money or other property from the business, the disposition or withdrawal is included in determining whether unpaid installments are accelerated. The committee intends that the Treasury Department will issue regulations to ensure that dispositions or withdrawals from the corporation carrying on an active business are considered only once in determining whether tax is accelerated.

Another special rule provides that, under the provision providing for acceleration of unpaid installments, if an estate has undistributed net income in any year, dividends paid to the qualified holding company by the corporation carrying on the active business are treated as if the dividends were paid to the decedent's estate.

Effective Date

This provision of the bill applies to estates of individuals dying after the date of enactment.

Revenue Effect

This provision is estimated to decrease fiscal year budget receipts by $5 in 1985, $7 in 1986, $10 in 1987, $12 in 1988, and $15 in 1989.

N. Dollar Limits on Benefits Under Qualified Pension Plans for Airline Pilots (sec. of the bill and sec. 415 of the Code)

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the overall limits on contributions and benefits under qualified pension, profit-sharing, or stock bonus plans ("qualified pension plans"). In the case of a defined benefit pension plan, the dollar limit on annual benefits was generally reduced from an annual benefit of $136,425 to $90,000. If benefits begin before age 62, TEFRA requires that the dollar limit be actuarially reduced to reflect the value of early payment. Using a standard mortality table and 5 percent interest, the dollar limit at age 60 is $75,240.

Federal regulations require that commercial airline pilots retire after attaining age 60.

Reasons for Change

The committee recognizes that the TEFRA rules requiring an actuarial reduction in the dollar limits on benefits under qualified pension plans for retirement before age 62 affects commercial airline pilots who are required, by Federal regulation, to retire at age 60. The committee believes that it is inappropriate to require this actuarial reduction under these circumstances.

Explanation of Provision

Under the provision, the reduction for early retirement applies only to those airline pilots whose benefits begin before age 60 and the dollar limit for annual benefits beginning at age 60 is $90,000.

Effective Date

The provision is effective as if included in sec. 235 of TEFRA.

Revenue Effect

This provision will decrease fiscal year budget receipts by less than $5 million annually.

O. Removal of Distilled Spirits for Use in Production of Certain Nonbeverage Wine Without Payment of Tax (sec. 809 of the bill and sec. 5214 of the Code)

Present Law

An excise tax equal to $10.50 per proof gallon is imposed on distilled spirits produced in or imported into the United States (sec. 5001). This tax is determined upon removal of the distilled spirits from the distilled spirits plant or Customs custody (sec. 5006). In certain cases, distilled spirits may be removed without payment of tax (sec. 5214). Present law does not permit removal without payment of tax of distilled spirits other than wine spirits or brandy for use in wine production. Therefore, distilled spirits (other than wine spirits) used in a nonbeverage wine product must be removed taxpaid and a claim for refund made.

Reasons for Change

The committee determined that producers of nonbeverage wine products such as cooking wine should be permitted to use any type of distilled spirits in the production of those products without the necessity of paying tax on removal of the spirits and then claiming a refund. This treatment will enable U.S. producers of nonbeverage wine products to compete more effectively with producers of similar imported goods.

Explanation of Provision

The bill expands the circumstances under which distilled spirits may be removed from a distilled spirits plant without payment of tax to permit such a removal of any type of distilled spirits for use in producing nonbeverage wine products (e.g., cooking wine). This provision would not permit the use of wine products thereby produced in any beverage product.

Effective Date

This provision is effective on the date of the bill's enactment.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $1 million annually.

P. Investment Income from Subchapter S Corporations (sec. 810 of the bill and sec. 163(d) of the Code)

Present Law

Under present law, an individual's deduction for investment interest is generally limited to net investment income plus $10,000 (sec. 163(d)). Investment income includes dividends, interest, rents and royalties. Under the provisions of subchapter S in effect prior to the Subchapter S Revision Act of 1982, income from a subchapter S corporation was generally treated as dividends to the shareholders, and a court held that such income qualified as investment income. The 1982 Act provides that the character of subchapter S income flows through to the shareholders, and therefore S corporation business income will no longer be treated as investment income.

Reasons for Change

In order to lessen the impact of the transition to the new subchapter S rules for certain corporations, the committee wishes to allow shareholders of S corporations an additional two years to treat the S corporation income as investment income.

Explanation of Provision

The bill provides that a shareholder may elect to treat income of a corporation with a subchapter S election in effect for its last taxable year beginning before 1983, as investment income, for purposes of section 163(d), except to the extent that income is attributable to services of the taxpayer.

Effective Date

The provision is effective for taxable years beginning in 1983 and 1984.

Revenue Effect

The provision will decrease revenues by a negligible amount.

Q. Tax Treatment of Certain Nonprofit Dependent Care Organizations (Sec. 811 of the bill and secs. 170, 2055, and 2522 of the Code)

Present Law

Under present law, nonprofit organizations which are organized and operated exclusively for religious, charitable, educational, or certain other purposes, and which meet certain other requirements, are exempt from Federal income tax (sec. 501(c)(3)). Contributions to such organizations are deductible for income, gift, and estate tax purposes (secs. 170, 2055, 2522).

The Internal Revenue Service has recognized that nonprofit day care centers may be eligible for tax exemption and tax-deductible contributions where enrollment is based on the financial need of the family and the need of the child for the program, or where the center provides pre-school age children of working parents with an educational program through a professional staff of qualified teachers (Rev. Rul. 68-166, 1968-1 C.B. 223; Rev. Rul. 70-533, 1970-2 C.B. 112). Under the facts involved in these rulings, the IRS concluded that any private benefits derived by the parents of enrolled children or the employer of the parents were merely incidental to the public benefits resulting from the center's operation, and hence were not inconsistent with tax exemption. Similarly, the Tax Court has upheld the tax-exempt status of child care centers in circumstances where the custodial services of the center were incidental to its educational activities,[1] but not where the center's operations do not serve the community as a whole.[2]

Reasons for Change

The committee understands that definitional difficulties have arisen with respect to whether certain nonprofit day care centers which provide after-school care to children or care for infants or toddlers meet the present law requirements for tax-exempt status and eligibility for tax-deductible contributions as educational or charitable organizations. Accordingly, the committee believes that certain nonprofit day care centers which make their services available to the general public should so qualify.

Explanation of Provision

The bill provides that the term "educational purposes," as used for purposes of tax-exempt status under section 501(c)(3) and eligibility for tax-deductible contributions under sections 170, 2055, and 2522, includes the providing of care of children (away from their homes) if both (1) substantially all of the child care provided by the organization is for the purposes of enabling individuals to be gainfully employed, and (2) the services provided by the organization are available to the general public.

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[1] *San Francisco Infant School, Inc.* v. *Comm'r,* 69 T.C. 957 (1978), acq. 1978-2 C.B. 2.

[2] *Balt. Regional Joint Board Health and Welfare Fund* v. Comm'r, 69 T.C. 554 (1978).

Effective Date

The amendment made by this provision of the bill is effective for taxable years beginning after the date of enactment.

Revenue Effect

The provision is estimated to reduce budget receipts by less than $5 million annually.

TITLE IX—SOCIAL SECURITY DISABILITY BENEFITS REFORM PROVISIONS

A. Purpose and Scope

The committee's bill also amends Title II of the Social Security Act to provide for necessary reforms in the administration of the social security disability insurance program. The disability insurance program has attracted substantial Congressional attention over the last two years, primarily because of the numbers of beneficiaries whose benefits have been terminated. The review of current beneficiaries that has produced these terminations was mandated by Congress, but was accelerated in pace in March, 1981. There has been no suggestion that those receiving disability benefits should never be examined again, but the committee believes that the process over the last several years has resulted in erroneous termination of benefits for at least some people.

Therefore, the committee's bill addresses three major areas where reform appears to be most critically needed: in the standards for determining eligibility for disability benefits, both for new applicants and more particularly for current beneficiaries being reviewed; in the structure of the administrative process itself; and in the way in which the Social Security Adminstration makes disability policy, both on its own initiative and in conjunction with rulings of the Federal courts. There are in addition several miscellaneous provisions concerning payments to vocational rehabilitation agencies, publication of policies concerning consultative medical examinations, and establishment of new positions for social security staff attorneys.

The overall purpose of the bill is, first, to clarifly statutory guidelines for the determination process to insure that no beneficiary loses eligibility for benefits as a result of careless or arbitrary decision-making by the Federal government. Second, the bill is intended to provide a more humane and understandable application and appeal process for disability applicants and beneficiaries appealing termination of their benefits. Finally, the bill seeks to standardize the Social Security Administration's policy-making procedures through the notice and comment procedures of the Administrative Procedures Act, and to make those procedures conform with the standard practices of Federal law, through aquiescence in Federal Court of Appeals rulings.

The committee is deeply concerned about the erosion of public faith and confidence in the social security disability programs, and in the agency as part of the Federal government, that has occurred as a result of the changes in policies over the last several years. The guidelines established in this bill appear to the committee to be the best way to restore confidence in the program. The committee believes it is crucial to continued public support for the social security program as a whole for the public to understand that the program will be administered according to the law rather than by constantly shifting and possibly arbitrary policies.

B. Explanation of Provisions

1. Standards of disability (secs. 901-903 of the bill)

a. Overview

Sections 901-903 of the bill are designed to clarify the criteria that must be used in evaluating whether new applicants or current beneficiaries are disabled. The criteria laid out in present law are few, and brief:

(1) Disability is defined in Section 223(d)(1) of the Social Security Act as the inability to engage in any substantial gainful activity by reason of a medically determinable impairment which can be expected to result in death or to last at least 12 months;

(2) A second sentence added in 1967 expanded on this definition with respect to the type of work an individual must be unable to perform, i.e., not only his previous work but, considering his age, education and work experience, any work existing in the national economy, regardless of the existence of any specific job he might actually be hired for.

The committee does not intend to alter the current definition, which embodies the intent of Congress that only those who are verifiably unable to work are to be found eligible for disability benefits. However, it must be recognized that determining inability to work in each individual case must ultimately rest to some degree on the subjective judgment of the examiner.

In response to this inherent subjectivity, the disability determination process has developed into an elaborate system of checks and balances designed to prevent individual judgment from outweighing national policies defining who is totally disabled. The initial decision is made according to the submitted clinical findings, a deliberate paper decision that avoids as much as possible the personal influence of either the claimant or of his physician. The examiner's decision is then subject to several different kinds of reviews, through the quality assurance system and through a multilayered appeals system, in an attempt to ensure as much objectivity as possible in an inherently subjective decision.

The process each examiner follows in making disability decisions at the State agency level is known as the "sequential evaluation" process. After checking to see whether the claimant is currently working at the substantial gainful activity (SGA) level, the examiner next must determine whether the individual has a severe impairment; if he does not, the process goes no further.

SSA has been criticized for using the severe/non-severe test at this stage of the process as a way to terminate benefits, or deny initial applications without fully evaluating the person's real ability to work. This criticism has been particularly strong in the case of multiple impairments, because the regulations require that where the person has several impairments, of which none are severe, no disability can be found.

At this step and later on in the process, current policy is to take subjective evidence of pain into account only if objective medical data, such as laboratory tests and documented case history, show a specific impairment that can reasonably be concluded to be causing the pain. This policy is an attempt to ensure that a finding of disability is based only on "medically determinable" impairments, as required by the statutory definition, and to reduce the level of subjectivity inherent in the disability determination.

After finding that the person has a severe impairment, the examiner must determine whether that impairment matches the listings of disabling impairments or if, in combination with other less severe conditions, the total impairment equals the severity level in the listings (the "meets or equals" test). If it does not, the examiner must assess the person's "residual functional capacity"— ability to do either his past work or any other work in the national economy. SSA evaluates work capacity in a variety of ways, using all available evidence of work or productive activity in sheltered workshops, home settings and competitive work environments.

This evaluation is difficult to make for beneficiaries who have been receiving benefits for some time, particularly for those with mental impairments, whose illness may allow certain types of activity with limited circumstances, but possible not under the day to day pressure of a real job. SSA has been particularly criticized for not giving sufficient weight to the longitudinal medical and work history of mentally impaired claimants.

In summary, SSA's current policies for interpreting the definition of disability place a heavy emphasis on objective evidence to support a finding of disability. The sequential evaluation is designed to create a series of clear decisions for the examiner, particularly as to the severity of the impairment, which are to be made based only on verifiable clinical data, so that the subjectivity of the decision can be kept to a minimum.

While this process allows tighter control over the number of people allowed benefits, and therefore over program costs, it can result in denial of benefits for people who cannot be expected to work in view of their total condition. The definition of disability clearly states that benefits are to be paid to those who are unable to work because of severe impairment, not merely to those who meet a certain impairment level and incidentally are unable to work. The current procedures thus represent a compromise between complete evaluation of every individual's particular circumstances, on one hand, and, on the other, a completely objective "screen" of characteristics which must be satisfied in order to find a person disabled.

The committee wishes to reaffirm that the purpose of the disability insurance program is to provide benefits only for those who are unable to work. It is therefore completely appropriate for the Social Security Administration to periodically review beneficiaries who are not deemed to be permanently disabled, in order to ensure that the law is being carried out.

However, the committee is concerned that the consideration of eligibility for disability benefits be conducted using criteria that clearly reflect the intent of Congress that all those who are unable to work receive benefits. It is of particular concern that the Social

Security Administration has been criticized for basing terminations of benefits solely and erroneously on the judgment that the person's medical impairment is "slight," according to very strict criteria, and is therefore not disabling, without making any further evaluation of the person's ability to work.

The committee believes that in the interests of reasonable administrative flexibility and efficiency, a determination that a person is not disabled may be based on a judgment that the person has no impairment, or that the impairment or combination of impairments are slight enough to warrant a presumption that the person's work ability is not seriously affected. The current "sequential evaluation process" allows such a determination, and the committee does not wish to eliminate or seriously impair use of that process. However, the committee notes that the Secretary has already planned to re-evaluate the current criteria for non-severe impairments, and urges that all due consideration be given to revising those criteria to reflect the real impact of impairments upon the ability to work.

It is also assumed that the length of time the beneficiary has been on the benefit rolls will be taken into account in assessing the person's residual functional capacity. The committee is concerned that the periodic review of beneficiaries who are over age 50, and who have been on the benefit rolls for some period of time, may result in termination of benefits for many in that age group who realistically cannot be expected to re-enter the work force given their age and length of time in receipt of benefits. Therefore, the committee directs the Secretary to re-evaluate the consideration given in the determination process for such beneficiaries to past relevant work, in order to ensure that older beneficiaries who have been receiving benefits for several years are carefully reviewed for realistic ability to work.

The committee is also concerned that the evaluation of the person's ability to work be made in a context that accurately reflects the capacity to work in a normal, competitive environment. Such an evaluation does not necessarily require a full "work evaluation" by a vocational expert in each case, although such evaluations are desirable and should be used wherever feasible where the additional information provided by such evaluations would be helpful in deciding close cases. The committee particularly urges that such evaluations should be used if at all possible in cases of mental impairment, where necessary to aid in determining eligibility in "borderline" cases, at the point in the sequential evaluation process where such evaluations would normally be done under current policy.

It is also important in such cases to evaluate the person's entire work history, rather than to examine only recent evidence of work activity, in order to determine whether the person can really engage in substantial gainful activity. The committee emphasizes that in any evaluation of work activity, the presence of work in a sheltered setting or workshop cannot in and of itself be used as conclusive evidence of ability to work at the substantial gainful activity level. Such work may be used in conjunction with other evidence that the beneficiary or claimant is not disabled, but benefits should not be denied simply because of sheltered work experience.

The committee emphasizes that the foregoing discussion does not constitute any change in the current definition of disability, but rather is a clarification of the intent of Congress that disability benefits should be granted to those who are unable to work because of a medically determinable impairment. Sections 901 and 903 of the bill provide statutory standards for determining disability: section 901 establishes specific criteria for re-examination of current beneficiaries, while section 903 establishes criteria for multiple impairment cases both on initial application and on re-examination. Section 902 mandates a study and recommendations on the possible use of subjective evidence of pain in determinations of disability, with a view toward establishing standards in this area through legislation after consideration of the report. Taken together, these new statutory standards will provide much needed clarification of the law and of Congressional intent.

The committee also wishes to emphasize that the social security disability insurance program is a Federal social insurance program, fully funded by the disability insurance trust fund (including State and Federal administrative costs), and administered by the Social Security Administration. While disability determinations are made by State disability agencies under voluntary agreements with the Department of Health and Human Services, policies for making these evaluations are and must be established at the Federal level, for implementation on a nationwide basis.

The committee is aware of the actions several States have taken in response to conflicting interpretations of the applicable provisions of law relating to the termination of benefits—actions which, in effect, represent a failure to comply with certain policies issued by SSA. While such actions must be regarded as questionable, the current confusion that has given rise to them is understandable and creates a compelling need for congressional clarification. We believe the relevant issues would be resolved by this bill and that, as a result, the basis for any such actions would be eliminated.

The committee bill makes clear what the law is with regard to certain areas of contention such as the standard for medical improvement. With respect to the area that is not so clarified, i.e., the use of subjective evidence of pain in disability determinations, the intent of Congress is clear: upon receipt of information adequate to form a reasonable basis for legislating, Congress will enact a specific policy concerning pain; until that time, no change in policy by the Social Security Administration is mandated by this bill.

b. Standard of review for terminations of disability benefits (sec. 901 of the bill)

Section 901 of the bill provides for the first time in the social security statute a specific standard that must be met before a disability beneficiary can be found to be not disabled. SSA has always scheduled a certain percentage of disability beneficiaries for re-examination to determine whether they are still disabled. The statute contains no guidelines for appropriate criteria to govern these re-examinations, other than the definition of disability.

From 1969 to 1976, SSA's policy, established originally by an administrative law judge in one hearing, was to not terminate benefits for anyone whose condition had not improved since the initial determination of eligibility. This policy wass reversed in 1976 in internal SSA directives. Shortly thereafter, the Supreme Court, in *Matthews v. Eldridge,* agreed with the agency that the buden of proving continuing eligibility for benefits was on the beneficiary.

However, possible as a result of the pre-1975, a decreasing number of people seemed to be leaving the benefit rolls to return to work in the 1970's—the rate of benefit terminations due to recovery or return to work fell from 32 percent per thousand beneficiaries in 1967 to 16 persons per thousand in 1975. As a result, Congressional interest was expressed, beginning in 1978, in requiring SSA to look at people who had been receiving benefits for a long time to see if they were still eligible. SSA's standard procedures for re-examining only a small number of beneficiaries seemed to be inadequate in light of the declining number of benefit terminations for return to work.

The 1980 Social Security Disability Amendments made a number of significant changes in disability program operations. Responding to the need for more effective management of the program, the legislation required a dramatic increase in the amount of management review and oversight of the program, with the objective of tightening central Federal control over State agency and ALJ decisions, and re-invcigorating ongoing review of current beneficiaries. Of particular concern in connection with Section 901 of the bill was the provision requiring review at least once every three years of all beneficiaries not permanently disabled, beginning in January, 1982.

However, the Department of Health and Human Services moved up the date of implementation of this provision, and accelerated the rate of review of current beneficiaries beyond the schedule required in the 1980 Amendments. Beginning in March 1981, SSA began sending out about three times the normal number of CDI cases: about 160,000 were done in FY 1981, 496,771 in FY 1982, and 640,000 were budgeted for FY 1983 prior to the Secretary's new initiative to slow down the review process announced in June, 1983.

The rate of terminations in these CDI cases at the initial level currently is about 45 percent, which is very close to the rate for reexaminations done in previous years. However, the types of cases being examined in the accelerated CDI process are different from the relative few cases SSA used to designate for re-examination because they had great potential for medical recovery.

The new caseload consists in large part of beneficiaries who were not scheduled for re-examination before, and who in many cases were found disabled several years ago, during and after the inauguration of the SSI program, when the decision criteria may have been less precise than those being used today. The magnitude of the CDI initiatives has meant that a very large number of the cases SSA considers were wrongly allowed (either by the original State examiner or by an ALJ overturning the State agency) are being re-examined for the first time since the policy change on medical improvement in 1976.

These re-evaluations are based on current standards and medical criteria which are in many cases more clear-cut and exact than the standards on which benefits were initially [illegible], and reflect improvements in medical technology and treatment. Moreover, the overall "adjudicative climate" has been generally more rigorous than in earlier years, so that re-examined beneficiaries, now being looked at as if they are new applicants, will have more rigorous standards applied than in their initial determination. For example, beneficiaries who originally were allowed benefits because their combination of impairments roughly approximated the level required by the medical listings ("equals the listings"), are now more likely to be evaluated according to whether their impairment matches the medical criteria ("meets the listings"), which are themselves different from the criteria in 1970.

It has been alleged that the agency, particularly in mental impairment cases, has focused too heavily on the severity of the medical condition without making an adequate evaluation of the beneficiary's ability to work, with the result that benefits have been terminated for many people who cannot function in a work environment. These policies seem to have been in effect well before the inauguration of the accelerated review in 1981, but the combination of an apparently more restrictive policy and reviews of large numbers of beneficiaries have resulted in widespread complaints about SSA's procedures.

These policies have come under severe criticism in Federal courts, particularly in the Ninth Circuit Court of Appeals which has ruled twice that SSA must demonstrate either medical improvement or (in the later ruling) clear and specific error in the original award, in order to terminate disability benefits. Similar "medical improvement" standards have been declared in other circuit courts as well, and an increasing number of State governors have declared those judgements to be binding on ALJ's and State adjudicators in opposition to Federal policy guidelines.

In summary, the re-examination of large numbers of current disability beneficiaries has resulted in termination of benefits for many beneficiaries whose medical condition has not changed substantially since they were allowed benefits. Medical impairments are being closely examined to determine whether they meet today's standards—if the impairment is now judged to be not severe, the person's benefits are terminated, whether or not the impairment is any different from when the person was first allowed. The primary issue therefore is whether a person's benefits should be terminated because standards of disability have changed since the individual was first allowed benefits, so that he is judged able to work under current criteria even though his medical condition has not improved.

The committee recognizes that the problems with the current review have arisen, at least in part, because the criteria for termination of benefits as a result of review were left unstated in the law. SSA has therefore had wide discretion to apply whatever standards it deemed appropriate—and since the standards of the current program apparently are stricter than those in the past, applying today's standards has meant eliminating benefits for many more beneficiaries than was anticipated when the 1980 Amendments were enacted.

Therefore, section 901 of the bill establishes a clear "medical improvement" standard that creates a category of beneficiaries who, because their medical conditions have not improved, are presumed to be unable to work and who therefore must continue to receive benefits. This standard contains several important exceptions which would allow termination of benefits even where the beneficiary's medical condition has not improved: where the beneficiary is performing substantial gainful activity, where medical or rehabilitation techniques allow the person to work despite his unchanged condition, where the original decision was in error, or was fraudulent, or where new or improved diagnostic techniques or evaluations reveal that the impairment is less disabling than originally thought.

The committee believes these exceptions address several legitimate concerns: that benefits which were improperly allowed originally should not be continued; and that the documented effects of medical or vocational therapy on an individual's ability to perform SGA, and the result of a reassessment of the severity of an individual's impairment based on the application of new or improved diagnostic or evaluative techniques need to be taken fully into account in making continuing disability determinations. The committee emphasizes, however, that the application of these exceptions is contingent on the satisfaction of specified requirements relating to documentation, the acquisition of appropriate medical and vocational evidence and the use of specified techniques or procedures. Thus, with respect to the effect of medical or vocational therapy on an individual's ability to perform SGA, the exception would be applicable only if it is demonstrated, on the basis of new medical evidence and a new assessment of the individual's residual functional capacity (RFC), that the individual has been the recipient of services which reflect advances in medical therapy or technology (or the recipient of any vocational therapy) which has had the effect of restoring the individual's ability to engage in SGA.

Similarly rigorous requirements must be satisfied with respect to the use of the exception relating to the results obtained from the application of new or improved diagnostic or evaluative techniques which may disclose that the individual's impairment is less disabling than originally thought at the time of the prior determination (for example, the individual has the ability to do his previous work, that is, usual work or other past work). The committee recognizes that there may be some cases in which the prior decision that the individual was disabled was based, in part, on an assessment of residual functional capacity that was either improperly or inadequately documented. While it might be argued that in such cases a finding of clear error ought to be made, it is not intended that the standard of "clearly erroneous" be loosely applied to encompass inadequate development of a case. Moreover, the cases involved here do not represent "erroneous determinations"; rather, they reflect decisions properly made in accordance with the state of the art at the time the decisions were made and in accordance with the administrative procedures in place at that time. The fact is, however, that changing methodologies and advances in medical and vocational diagnostic and evaluative techniques have given rise to improved methods for documenting and evaluating medical evidence, RFC, and vocational factors. Where such methods, properly used, permit the development of more accurate, objective and valid results, they should not be ignored.

The committee intends that where SSA uses new or improved evaluation techniques to determine and document an individual's ability or inability to work, and where this new determination shows that an individual is not as disabled as initially considered (for example, the individual can do his previous work), such evidence may serve as the basis for a finding under this section that the individual is not disabled within the meaning of Title II of the Social Security Act.

The committee expects that this exception will be carefully applied and that any determinations made in accordance with this provision will be fully documented, accurate and consistent with objective medical and vocational findings. Since these cases may involve individuals who have been receiving disability benefits in good faith, the committee re-emphasizes here that it expects the Secretary to re-evaluate the consideration given in the continuing disability process to factors such as age and duration in benefit status. Nonetheless, when appropriately and responsibly applied, this exception is available to assure the equitable attainment of the objectives of the program.

The committee is aware that in some cases adjudicated in prior years all the medical information relevant to the initial decision may not still be in the beneficiary's file and that such a situation would preclude the possibility of making an objective finding with respect to a change in the severity of the beneficiary's impairment. In such cases, SSA would be authorized to secure such medical information as may be necessary to fully reconstruct the medical records and data that were utilized in making the initial decision. The committee emphasizes, however, that the inability to reconstruct such records and data cannot serve, in and of itself, as a basis for a determination that there has been medical improvement. Such a conclusion may be reached only if the records applicable to the initial decision have been fully reconstructed and the prior and current medical evidence discloses that there has in fact been medical improvement.

c. Study concerning evaluation of pain (sec. 902 of the bill)

The social security statute currently provides no guidance on the use of allegations of pain by the claimant in the disability determination process. Because the definition of disability states that inability to work must be "by reason of a medically determinable impairment", the Social Security Administration has allowed allegations of pain to be used only if a specific physical impairment exists to which the pain can be reasonably attributed.

However, many claimants allege disability primarily or substantially as a result of disabling pain that cannot be specifically attributed to a physical condition. Because the law itself is not explicit, allowance decisions at the ALJ and Federal court levels have not infrequently depended heavily on this kind of subjective evidence. Almost every circuit court of appeals has ruled at some point over the last ten years that eligibility should be based on subjective evidence of pain, at least in cases where it corroborated by testimony of other witnesses.

The committee is concerned that a fragmented standard is now in effect for using subjective evidence of pain, depending on whether the beneficary has pursued his claim through the ALJ or district court level. While it may well be the case that pain in and of itself, regardless of its cause, can result in inability to work, there is apparently still no way to verify the existence of such pain through objective medical testing.

The committee is therefore reluctant at this time to allow determinations of disability to be based on such subjective criteria. There is plainly a critical need for a clear legislative policy, to be applied to all cases on a nationwide basis; it is not appropriate for the Federal courts to establish policy on such an issue simply because the statute is insufficiently specific. However, the committee cannot, at this time, mandate such a policy, simply because there is not enough information about the impact this kind of change would have on the types of cases that would be allowed and on the costs to the disability program.

Therefore, section 902 of the bill requires the Secretary in conjunction with the National Academy of Sciences, to conduct a study on the question of using subjective evidence of pain in determining disability, and on the question of the state of the art of preventing, reducing or coping with pain, and to report to the Congress by April 1, 1985 on the results of the study. It is anticipated that at that time, Congress will be able to develop a satisfactory statutory standard.

The committee also directs the Secretary to conduct such studies as are necessary to obtain complete information and statistics on both the fiscal costs and administrative feasibility of eliminating the 5-month waiting period for disability benefits for persons diagnosed by their physicians as terminally ill with less than 12 months to live. The results of such studies shall be presented to the Congress no later than October 1, 1984.

d. Multiple impairments (sec. 903 of the bill)

Under current law, the first step in the sequential evaluation process through which the disability determination is made is to determine whether the applicant has a severe impairment. If SSA determines that a claimant's impairment is not severe, the consideration of the claim ends at that point. In cases where a person has several impairments, none of which meet the standard for "severe", he is judged not disabled, without any further evaluation of the cumulative impact of his impairments on his ability to work.

The committee believes that this does not represent a realistic policy with respect to persons with several impairments which may in many cases interact and effectively eliminate the person's ability to work. While it is clear that the determination of disability must be based on the existence of a medically determinable impairment, there are plainly many cases where the total effect of a number of different conditions can safely be characterized as disabling, even if each by itself would not be. Section 903 of the bill therefore requires that in determining whether an individual's physical or mental impairment or impairments are so severe as to be disabling, SSA must consider the combined effect of all the individual's impairments without regard to whether any individual impairment considered separately would be considered severe.

2. Disability determination process (secs. 904–908 of the bill)

a. Moratorium on mental impairment reviews (sec. 904 of the bill)

Serious questions have been raised by Federal courts, professionals in the fields of psychiatry and vocational counseling and the General Accounting Office about the adequacy of SSA's Listing of Mental Impairments and the appropriateness of SSA's current methods for assessing residual functional capacity and predicting ability to work in individuals with mental impairments. While the validity of all these criticisms may be subject to some debate, it is clear that in many cases individuals have been improperly denied benefits. Moreover, the Secretary has determined that a full scale re-evaluation of the Listings and current procedures is necessary and, on her own motion, has imposed a moratorium on reviews of mental impairment cases classified as functional psychotic disorders. However, the moratorium imposed by the Secretary does not include all mental impairment cases that will be affected by changes in the listings and procedures, does not provide a precise timetable for the review and resolution of the pertinent issues and does not stipulate how the results of these changes are to be subsequently implemented.

The committee agrees that a moratorium of the kind imposed by the Secretary is warranted. However, the committee is concerned about the need to establish clear guidelines with respect to the review process, the timeframe for conducting the re-evaluation and procedures for the disposition of cases, including new applications and prior CDI's in the categories affected by the moratorium. The purpose of section 904 is to provide these guidelines.

Under section 904 a temporary delay would be imposed on reviews of all mental impairment cases until the Secretary revises the criteria embodied under the category "Mental Disorders" in the "Listing of Impairments." The revised listings and procedures for assessment of residual functional capacity are to be designed so as to realistically evaluate the ability of a mentally impaired individual to engage in substantial gainful activity in a competitive environment. Regulations establishing such reviewed criteria and listings are to be published no later than 9 months after the enactment. Moreover, the Secretary is required to conduct this re-evaluation and to prepare the appropriate regulations in consultation with the Advisory Council on Medical Aspects of Disability (created under section 912 of the bill).

This delay of reviews would apply to all CDIs of mental impairment cases upon which a timely appeal was pending on or after June 7, 1983 or on which no initial decision has been rendered as of the date of enactment, unless the individual is engaged in substantial gainful activity or fraud is involved.

Initial cases denied during the moratorium period are to be reviewed by the Secretary as soon as feasible after the new criteria are established, and those with mental impairments who were denied benefits or had their benefits terminated between March 1, 1981 and the date of enactment will have their cases reopened as of the most recent prior determination if they reapply within one year. Benefits would be paid as of the date of reapplication but the individual's insured status would thus be protected.

The committee is cognizant of the fact that revision of the listings in the mental impairment area could potentially result in an increase in the cost of the disability program. For that reason, the committee intends to monitor closely the cost effects of these revisions and directs the Secretary to report to the Committee on Ways and Means and the Senate Committee on Finance on the cost effects of any proposed changes in the listings 30 days in advance of the implementation of the regulations.

b. Face-to-face hearings in State disability determination agencies (sec. 905 of the bill)

Decisions as to whether or not an individual is disabled are made by 54 State disability agencies under agreements with SSA. These decisions may be appealed. Currently a disability claim or a CDI may go through five or more decision levels:

(1) The initial decision by the State agency, which if adverse can be appealed to

(2) the reconsideration level, also conducted by the State agency, which if adverse can be appealed to

(3) the Federal administrative law judge hearing, followed by, if adverse,

(4) an appeals council review; and finally

(5) if all prior decisions are adverse, the claimant can file an appeal in the Federal court system.

Under present law, the Federal Administrative Law Judge (ALJ) is the first level at which the disabled individual meets face-to-face with a decisionmaker. Initial interviews are conducted in SSA district or branch offices (of which there are about 1300) when the individual first applies or is first called in for a CDI, but no decisions are rendered there.

Even though no decisions are rendered in the social security district office, the committee recognizes the importance of the initial interview a CDI beneficiary or new applicant receives there. The district office has traditionally played a major role in assuring a full explanation of the program, of the individual's rights, the procedures involved, and in providing assistance to the individual in pursuing his or her claim.

P.L. 97–455 mandated that by January 1, 1984, individuals whose benefits are terminated due to a medical review (CDI) must be given the opportunity to have a face-to-face evidentiary hearing at the reconsideration level conducted either by the Secretary or the State agency. Although it may be necessary for logistical reasons for the Secretary to implement this provision in many areas of the country through the use of SSA hearings officers, the committee would encourage the Secretary to offer State agencies the option to conduct these face-to-face hearings. Since, under the provisions of the committee's bills, this reconsideration hearing would be only a temporary transitional procedure which would be phased out as the State agencies implement a face-to-face interview at the initial State agency decision level, State agencies could acquire valuable experience in conducting the transitional reconsideration hearing.

There is virtually unanimous agreement about the desirability of providing for a face-to-face meeting between the disability beneficiary and the administrative decisionmaker. The committee believes that such a meeting at the initial stage in the adjudicative process would permit State agency disability examiners to better assess the individual's residual functional capacity and assure that all relevant medical and vocational information has been obtained. Moreover, an interview at the initial State agency level, rather than at some later stage, would both simplify and expedite the decisionmaking process.

Consequently, section 905 provides for the implementation, no later than January 1, 1985, of face-to-face evidentiary interviews by all State disability agencies at the initial decision level for all medical termination cases. Under this provision, the State agency would send the beneficiary a preliminary notice of an unfavorable decision and the claimant would have 30 days in which to request a face-to-face meeting before a formal determination is made. The present reconsideration level would be abolished upon implementation of the State interviews. The committee emphasizes that where it is possible it would prefer that this provision be implemented earlier than January 1, 1985, and that where this occurs the transitional reconsideration hearings would be terminated.

The committee also endorses the concept of instituting face-to-face hearings at the initial, State level, and of abolishing the reconsideration level, for initial claims as well as CDI review cases. However, it is recognized that this procedure would be a complicated and major change for the program necessitating further study and preparatory administrative planning. As a result, section 905 also requires the Secretary to initiate demonstration projects with respect to face-to-face evidentiary meetings at the initial level of State agency determinations for new applicants and requires the Secretary to report to the Congress by April 1, 1985, on these projects. These projects must be conducted in a minimum of five States with the participating States to be selected no later than January 1, 1984. Where the projects are initiated, the reconsideration level would be eliminated.

The committee emphasizes that, where feasible, these demonstration projects should be implemented prior to the dates in the bill and notes that some States have expressed a strong interest in testing out this procedure. Since the committee is concerned that there be a full and cooperative effort made to implement and carry out all phases of a face-to-face interview in initial cases, the committee believes it would be appropriate to use these particular States in the demonstration projects.

c. Payment of benefits during appeal (sec. 906 of the bill)

P.L. 97-455, passed by Congress in December 1982, included a provision to allow beneficiaries whose benefits had been ceased because of a medical review of their eligibility to elect to continue receiving benefits until an ALJ has rendered a decision on the case. If the case is denied, then the benefits, except for Medicare, are subject to recoupment (subject to the hardship waiver standards already in law). This provision, however, was adopted on a temporary basis only—until further consideration could be given to the CDI issue in the 98th Congress. Thus, under present law, no extended payment can be made after June 1984 and the provision applies only to cessations occurring before October 1, 1983. For cessations after that date the program will revert to prior law which provided benefits for the month of cessation and two additional months. Since January approximately 113,000 individuals have elected to continue benefit payments during appeal.

Section 906 provides on a permanent basis for the continuation of benefits during appeal in all CDI cases through the decision of the Administrative Law Judge. Where the ALJ's decision is adverse to the beneficiary, such benefit payments would be subject to recoupment as under present law. The Secretary also must report to the committee on Ways and Means and the Committee on Finance by July 1, 1986, on the impact of this provision on expenditures from the social security and Medicare trust funds and the rate of appeals to ALJs. The committee believes, based on the experience under the present temporary provision, that providing for continuation of payments during appeal helps considerably to ease the severe financial and emotional hardships that would otherwise be suffered by disabled persons.

In addition, it is recognized that beneficiaries may be reluctant to elect to receive continued benefit payments for fear of not being able to repay the benefits provided if the decision of the Administrative Law Judge is unfavorable. The committee intends that at the time beneficiaries are given the opportunity to make this election they be informed that, in the event of an unfavorable determination, they might be eligible for a waiver or for a long-term repayment plan. The committee further intends that the Secretary take into account individual circumstances in making a determination as to whether or not to waive the overpayment.

d. Qualifications of medical professionals (sec. 907 of the bill)

A shortage of qualified medical personnel has been a chronic problem in the social security disability program. Knowledgeable medical consultation is necessary for accurate decisions, and particular concerns have been raised that in the area of mental impairments a general medical knowledge is often not sufficient for a full evaluation of an individual's claim. The committee notes that through the encouragement of the Social Security Administration almost all State agencies now have staff psychiatrists available.

Section 907 requires that where there is an unfavorable decision in a mental impairment case, a qualified psychiatrist or psychologist must complete the medical portion and the residual functional capacity assessment of the determination. The committee believes that this requirement will help assure an accurate determination of the individual's capacity for substantial gainful activity.

The committee would also encourage the Social Security Administration to urge States to secure qualified specialists in other areas of impairments and to examine methods (such as referrals to nearby States or to the SSA central office) for providing consultation with specialists where that would be helpful but is not locally available. The committee notes that requiring States to hire physicians in all specialties would be costly and in some States impossible. Nonetheless, the committee believes efforts should be made, to the extent feasible, to provide disability examiners with the expert consultation of specialists wherever that would be helpful in making an accurate decision.

In this and other areas the committee notes that efforts to gather every piece of evidence must be balanced against the time and resources required to do so. If the disability judgment takes too long or becomes too fraught with complicated procedures for gathering evidence it would be criticized on those grounds. Indeed, some courts have interposed time limits on how long the agency can spend in reaching a decision. Given the already substantial administrative costs of the program and the constraints imposed by individual States on securing additional personnel, the availability of resources is also a real consideration since imposing requirements for which there are not adequate resources generally causes additional disruption of the program—the opposite effect from that intended.

Nevertheless, concerns have been expressed that in an effort to process cases in an expeditious manner, procedures have been followed by SSA which inhibit the full development of medical and other evidence and which made it more difficult for disabled claimants fully to state their case.

The committee emphasizes the need to examine all relevant evidence in making a disability determination and the need to actively seek and pay particular attention to evidence from treating physicians, especially in chronic illnesses. SSA and State agency personnel share an obligation to asist the claimant in understanding the process and securing necessary medical data. The committee, therefore, requests that the Secretary report to the Congress on the current use of home visits by agency personnel and on whether there are other instances where a home visit would not now occur but which might be constructive in providing the agency with full information on a claimant.

Similarly, the committee is concerned that hearings locations (and face-to-face interview locations) be accessible to beneficiaries. Such offices should be located in buildings fully acessible to the handicapped; funding for medical evidence and travel should be provided, and the Social Security Administration should re-examine the current requirement that a beneficiary must travel at least 75 miles in order to qualify for travel reimbursement as this standard may be inappropriate in many locations in this country.

e. Regulatory standards for consultative examinations (sec. 908 of the bill)

Consultative examinations are medical examinations purchased by the agency from physicans outside the agency to secure medical information necessary to make a determination or to check conflicting evidence. Many concerns have been raised about the improper or generally unsupervised use of CE's and SSA has taken several steps to tighten up procedures in this area and particularly to restrict the use of doctors providing CE's on a volume basis (volume providers).

The committee is pleased to note that efforts are being made to provide more direction in the use of consultative examinations and would encourage SSA to redouble its efforts to secure reasonable fee structures for consultative examinations so that dependency on volume providers can be reduced. The committee also believes, however, that concerns about the use of consultative examinations would be lessened if policies now in effect with respect to consultative examinations (or any subsequent policies that may be developed in this area) were embodied in regulations. Section 908, therefore, requires that the Secretary promulgate such policies in regulations. Since the purpose of this provision is only to assure that the policies are published in regulations there is no intent or implication that any new claims or pending cases involving consultative examinations be delayed until the regulations are published. On the contrary, it is the committee's intent that such cases will continue to be processed and adjudicated as under present law.

The committee also notes that questions have been raised about SSA's application of the trial work provision of present law. In order to eliminate any possible misunderstanding or confusion about the intent of this provision, the committee reaffirms that recency of work and sustained work over several consecutive months is necessary for an individual to meet trial work conditions.

3. Miscellaneous provisions (secs. 909-913 of the bill)

a. Uniform standards for disability determinations (sec. 909 of the bill)

Section 553 of the Administration Procedure Act of 1946 established basic requirements for informal rulemaking, the process by which most regulations today are promulgated. This section requires general notice of proposed rulemaking to be published in the *Federal Register*, and an opportunity for public comment during a period of at least thirty days prior to the effective date of the rule. There are general exceptions to these requirements for interpretative rules, statements of policy, and rules of agency procedure, organization or practice, and where the agency for good cause finds the notice and comment procedures impractical or contrary to the public interest.

Social security benefits are not covered under Section 553 by virtue of an exception in Section 553(a)(2): "a matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts." This exception was part of the original APA, which was enacted at a time when there were very few Federal benefit programs: the social security disability and Medicare programs did not exist, and requirements for old age and survivor benefits were fairly explicit in the statute. In 1971 then-Secretary of HEW (now HHS) Elliot Richardson issued a statement placing all HEW programs voluntarily under the APA rule-making requirements.

However, SSA has continued to issue, as do other agencies such as the Internal Revenue Service, other policy statements, notably Social Security Rulings and the disability claims manuals (POMS), which are supposed to contain only clarification and interpretation of the policy contained in regulations. In addition, it has been alleged that real operating policy often develops as a result of State disability examiner reaction to return of specific allowance decisions deemed incorrect by SSA's Federal quality assurance review-ers. None of these sources of policy are open to public notice or comment.

The Bellmon Report on the hearings and appeals process, mandated by the 1980 Disability Amendments, found wide discrepancies in standards applied by the administrative law judges who are bound by the statute and regulations, as opposed to those applied by the State agencies who are bound by the POMS. This discrepancy may be a major reason for the high reversal rate of State agency denials at the ALJ level (standing at around 55 percent currently). As a result of this report, and the even higher reversal rate for CDI cases, there has been considerable pressure for uniform criteria at all levels of adjudication. SSA's response to this pressure was to begin incorporating the POMS into Social Security Rulings, which by regulation (20CFR 422.8) are to be relied upon as precedents in cases where the facts are essentially similar by ALJ's as well as State agencies.

The original exception for social security to Section 553 notice and comment requirements appears to have been more an accident of history than deliberate Congressional intent concerning all social security programs. When the APA was enacted, the disability program did not yet exist, and there were as yet very few social security beneficiaries of any sort.

Elimination of the APA exception for benefits has been recommended by the American Bar Association, and such a change has been incorporated in H.R. 2327, currently under consideration by the Judiciary Committee (a similar provision was previously approved by the Senate). There appears to be widespread agreement concerning eliminating just the exemption in 553(a)(2) for public benefits. There appear to be considerably greater complications in any changes to section 553(b)(A) which allows interpretive statements to be issued without public notice and comments. The Judiciary bill provision for limiting the exemption in 553(b)(A) for interpretive rules has been the subject of extensive debate for some time, and the bill retains the good cause exception in 553(b)(B).

The committee believes that it is appropriate for changes in policies that affect whether or not people receive disability benefits to be published in regulations allowing for public participation in the process. The policy decisions that must be made concerning disability determinations are far more complex than most policies in the old age and survivor programs, for one major reason: the determination of ability to work is an inherently difficult eligibility decision, while eligibility for retirement benefits depends on factors of age, quarters of coverage, and current earnings that are relatively easily determined.

However, the agency should also have sufficient flexibility to respond to changes in conditions quickly, and to issue administrative guidance to State agencies on a timely basis. There is clearly an appropriate role for issuance of informal policy clarification through rulings or other informal vehicles, and the committee has no wish to deprive the Social Security Administration of this ability.

Therefore, section 909 of the bill requires that the notice and comment provisions concerning issuance of regulations of section 553(a)(2) of the Administrative Procedures Act be applied to benefit programs under Title II. The provision does not affect the application of the exception in section 553 allowing informal policy clarifications to be issued through non-regulatory statements.

The committee emphasizes that the intent of the provision is to provide uniform standards for decision-making at all levels of the disability determination process, through the normal channels of rule-making that allow some degree of public participation in the process. In order to allow SSA some degree of flexibility in administering the extremely complex disability program, the bill allows the current practice of issuing Social Security Rulings to continue. However, it cannot be too strongly emphasized that the intent of the provision in eliminating the first exception is that all policy that substantially affects the determination of eligibility must be the same for all levels—State agency through administrative law judge—and must be issued through regulations.

This provision does not address directly the problem of informal policy direction given to State agencies through the quality assurance process. It may be difficult to prevent returns of cases to the State agency from having an effect on overall adjudicative policy, particuarly as the agency begins to review sixty-five percent of all favorable decisions. However, the committee intends Section 909 of this bill to produce uniform policy at all levels arrived at through processes open to public scrutiny. It is therefore expected that the Social Security Administration will take all steps necessary to limit the influence of quality assurance systems on day to day operations and policy of State agencies.

The committee is also aware of the grey area that exists between issues clearly having substantial policy impact that plainly belong in regulations, and issues clearly minor, administrative or merely clarifying that plainly belong in informal policy statements. It will be necessary, therefore, for the committee to closely monitor. SSA's activities with respect to this provision to assure that misunderstandings do not arise and that the desired ends are achieved. All administrative law relies heavily on the presumption that agencies will perform their duties in good faith, and the committee is, to a certain degree, relying on the expectation of good faith efforts by the agency to promulgate uniform standards through the regulatory process. If after some period of experience, it is found that this section has not had the desired effect of producing uniforms standards, further measures will be considered.

b. SSA compliance with certain Federal court decisions (sec. 910 of the bill)

Under the Federal judicial system, decisions by a circuit Court of Appeals are considered the "law of the circuit," and constitute binding case law to be followed by all district courts in that circuit. In general, if two circuits rule differently on a particular issue, the Supreme Court will review the issue to settle the dispute. The application of Supreme Court decisions to executive branch policies is virtually undisputed: if a particular policy is found unconstitutional, or contrary to the statute, that decision is binding on the agency. The appropriate application of circuit and district court decisions to agency policies is not as clear-cut.

Claimants for benefits under the Social Security Act may appeal State agency denials through several layers of administrative appeal, up through the appeals council. A claimant who wishes to continue to pursue appeal may next turn to the Federal district court with jurisdiction over his or her claim. The district court reviews the record as compiled by the agency to determine whether substantial evidence existed for the agency's decision. The district court's review is not a trial de novo, but rather is limited to a consideration of the pleadings and the transcript of the proceedings at the ALJ hearing. If the district court finds substantial evidence existed to support the agency's decision to deny benefits, a claimant may appeal the decision to the circuit court with jurisdiction, and ultimately petition the Supreme Court for certiorari.

Appeals of the agency's determinations to the Federal district courts are occurring with much greater frequency in recent years, imposing a workload burden on some district courts. Between 1955 and 1970, the total number of disability appeals filed with the Federal district courts was about 10,000 cases. In 1982 alone, nearly 13,000 disabliity cases were appealed to the district courts. The large increase in Federal court litigation on social security matters may be partly responsible for the present tension between SSA and the lower Federal courts.

Most disability cases decided in the Federal courts have little value as precedent for SSA decisions, since most reversals of agency determinations rest on the lack of substantial evidence for the agency's position. However, in many instances the court's opinion sets forth a statutory interpretation contrary to that of the agency, in the traditional manner in which Federal courts establish a rule of law, which is intended to be binding on the agency in later cases concerning the same issue. Circuit courts of appeals decisions in such cases have been issued with increasing frequency in recent years, with the clear expectation of the court that SSA would abide by its interpretation as would normally be the case with rulings having precedent as law within the circuit.

The Social Security Administration does not follow U.S. Courts of appeals decisions with which it disagrees, either nationwide or within the circuit of the ruling. While the agency does obey the court's ruling in the particular case being adjudicated, the interpretation of law from the court is not considered binding by the agency either for State disability agency operations or for Federal social security offices.

Moreover, the agency frequently does not appeal district court or circuit court opinions with which it disagrees. This practice ensures that the Supreme Court will not have the opportunity to review the issue and render a decision with which the agency would be compelled to comply. Social security ALJ's are not able to follow court of appeals decisions as precedent if the Supreme Court does not make a ruling or if the agency does not incorporate the circuit court's decision in social security rulings or regulations, which is most often the case in decisions SSA disagrees with.

SSA has been criticized for this policy, both by outside experts and Federal judges, on the grounds that it undermines the structure of Federal law, and in essence allows SSA to overrule the legal judgment of the Federal courts by administrative inaction.

SSA defends its policy on the grounds that a Federal benefits program should be administered uniformly on a national basis. It should be noted that in a brief before the Supreme Court in *Califano* v. *Yamasaki* (1979) the brief for petitioner Secretary Califano stated the following:

> When a statutory or constitutional issue is decided adversely to the Secretary in the course of judicial review obtained by an individual claimant, the Secretary will either appeal or abide by the unfavorable ruling. Repetitious litigation will thus not be necessary in order to establish a general legal principle applicable beyond the confines of a particular case. *Stare decisis* will impel the Secretary to follow statutory or constitutional decisions within the jurisdiction of the courts having rendered them.

This statement is in marked contrast to the repeated instances brought to the committee's attention of SSA's non-acquiescence policy, summed up in the following statement from the Associate Commissioner for Hearings and Appeals issued to Social Security ALJ's in January, 1982:

> The Federal courts do not run SSA's programs, and [SSA's adjudicators] are responsible for applying the Secretary's policies and guidelines regardless of court decisions below the level of the Supreme Court. (Social Security memorandum to its Administrative Law Judges)

Since 1978, there have arisen numerous cases in which circuit courts of appeals have ruled on issues where the Title II or XVI statute is unspecific or silent, most notably the issues of use of allegations of pain in disability determinations, and of whether a beneficiary whose condition has not medically improved can be found not disabled. Every circuit court of appeals in the country with the exception of the D.C. circuit has ruled that subjective evidence of pain must be allowed in finding claimants eligible for benefits. Several circuits, including the Ninth Circuit in two separate opinions, have ruled that SSA must show that a beneficiary has medically improved before ruling him no longer disabled. In all of these cases, SSA has not applied the court interpretation of the statute beyond the litigated case, and has not pursued an appeal to the Supreme Court.

The committee is concerned about the result of this non-acquiescence policy for claimants, the courts and SSA. First, while it is clearly of utmost importance that a Federal program be administered according to uniform, Federal standards, it is not clear that SSA's non-acquiscence policy substantially achieves that end. In fact, under the current policy, distinctions exist *within* circuits between policies applied to those claimants who pursue their claims to the appeals court level, and those who cannot. Such a difference will be particulary significant in those circuits where a class action suit applying to several thousand claimants is successful.

The committee is most concerned about the impact of this policy on beneficiaries and claimants, and on their relationship to the social security program. If a circuit court rules on a given issue such as medical improvement, it is a foregone conclusion that subsequent appeals to that court on that issue will be successful. By refusing to apply the circuit court ruling, SSA forces beneficiaries and applicants to re-litigate the same issue over and over again in the circuit, even though the agency is certain to lose each case.

The committee can find no reason grounded in sensible public policy to force beneficiaries to sue in order to obtain what has been declared by the Federal court as justice in a particular area. Such a policy creates a wholly undesirable distinction between those beneficiaries with the resources and fortitude to pursue their claims, and those who accept the government's original denial in good faith or because they lack the means to appeal their case. The strength of the social security program has always rested on the public perception that the agency's mission is to provide benefits to all those entitled to them, without undue delay or bureaucratic barriers. The increasingly adversarial character of the process for becoming eligible for disability benefits, and especially for retaining eligibility, does immeasurable harm to the public's trust in the social security program and in government as a whole.

The committee is also concerned about the increasing number and intensity of confrontations between the agency and the courts as SSA refuses to apply circuit court opinions. The Ninth Circuit court recently characterized the Secretary's defense of her non-acquiescence policy as "far from persuasive." The opinion goes on to state:

> . . . other circuits that have considered the question have already rejected the Secretary's argument that a Federal agency can legitimately ignore Federal appeals court precedents. See, e.g., Jones & Laughlin Steel Corp. v. Marshall, 636 F.2d 32, 33 (3d Cir. 1980); ITT World Communications v. FCC, 635 F.2d 32, 43 (2d Cir. 1980); Ithaca College v. NLRB, 623 F.2d 224, 228–29 (2d Cir.), cert. denied, 449 U.S. 975 (1980); Mary Thompson Hospital, Inc. v. NLRB, 621 F.2d 858, 864 (7th Cir. 1980); Allegheny General Hospital v. NLRB, 608 F.2d 965, 970 (3d Cir. 1979). Moreover, the cases cited by the Secretary to support her position appear to be inapposite. In short, our review of the relevant case law indicates that there is little chance that the Secretary will succeed in her argument that non-acquiescence is a legitimate policy, or, to put it more precisely, that she will persuade us that there is a strong probability that the plaintiffs would ultimately prevail on this fundamental issue.

While the issue of the constitutionality of the non-acquiscence policy may be in doubt, the undesirable consequences of escalating hostility between the Federal courts and the agency are clear. The committee sees no compelling reason why the Social Security Administration's interpretation of the statute, particularly in issues where the definitions are not specific or are completely silent on the issue, should be automatically considered superior to that of the Federal court.

SSA's reasons for the current policy appear to be based largely on the desire for consistent national administration of the program. It is also clear that Federal courts may frequently hand down decisions expanding agency policies in directions the agency and Congress may not wish applied on a national or regional basis. Since the guiding principle for Federal courts is the Constitution and the law, policy considerations such as cost constraints may play less of a role than they appropriately do in Congressional deliberations

In such instances, however, the committee strongly believes that Congress' judgment as to the appropriate policy should prevail. If the Federal circuit courts hand down decisions that appear detrimental to the purposes or operation of the program, either the Supreme Court should be given the opportunity to make a determination that remedies the situation, or Congress may well have to clarify the law. In such cases, Congress might reasonably expect the agency to propose appropriate remedial legislation. Short of legislative changes, however, the committee sees no reason to allow SSA to ignore the law as determined in each circuit by the highest Federal court simply because the administrators view the Federal court's decision as mistaken.

Therefore, Section 910 of the bill requires the Social Security Administration to either apply the decisions of circuit courts of appeal to at least all beneficiaries residing within States within the circuit, or appeal the decision to the Supreme Court. This provision applies to circuit court opinions issued after the date of enactment as well as to those opinions which the Secretary still has the opportunity to appeal to the Supreme Court as of the date of enactment.

c. Payment from trust funds for costs of rehabilitation services (sec. 911 of the bill)

Prior to P.L. 97-35 (1981 Reconciliation Act), up to 1.5% of the total amount of disability benefits could be transferred from the trust funds for payment of vocational rehabilitation services for SSDI beneficiaries. In FY 1980 the amount transferred was $110 million (the amounts transferred generally were well below the 1.5% ceiling). An additional $50 million in general revenue funds were expended for SSI disability recipients. A benefit cost study completed by the Social Security Administration found that in 1975 between $1.39 and $2.72 savings accrued to the social security trust fund for every $1.00 spent in this program.

P.L. 96-265 (the 1980 Disability Amendments) included a provision that DI and SSI benefits could continue even after medical recovery until the individual completed a vocational rehabilitation program in which he was participating provided he had not been expected to recover when he entered the program and provided the program would increase the possibility of the individual permanently leaving the rolls.

P.L. 97-35 abolished the general DI trust fund program and further provided the State VR agencies could be reimbursed only for the costs of services to beneficiaries that result in the beneficiary's performance of SGA (substantial gainful activity) for a continuous period of at least 9 months. Trust fund expenditures for FY 1982 were about $2 million and have remained under $10 million each year since.

Section 911 provides assurance to vocational rehabilitation service providers that they will be reimbursed for services rendered to participants in the medical recovery program (Sec. 301 of P.L. 96-265) by removing the restriction added by P.L. 97-35 that reimbursement could occur only where the beneficiary had performed nine months of SGA and by adding a provision that reimbursement will occur where the beneficiary without good cause refuses to accept or fails to cooperate with services in such a way as to preclude successful rehabilitation.

The committee is concerned that provision of vocational rehabilitation services to social security beneficiaries by improved. Therefore, it directs the Advisory Council on Medical Aspects of Disability to examine the whole area of the availability of vocational rehabilitation services for social security disability beneficiaries with particular attention to the following issues: How to assure that beneficiaries are referred for services in the most expeditious manner; whether the Secretary should contract directly with public and private non-profit providers of services, including rehabilitation facilities; how to provide adequate incentives for State and non-profit organizations to participate in programs available to social security beneficiaries; and what types of services should be provided to people whose SSDI benefits are terminated as a result of a continuing disability investigation and how best to provide such services.

The committee also reaffirms the congressional intent that payment for eligible vocational rehabilitation services, based on reasonable estimates, be made to service providers in advance.

d. Advisory Council on Medical Aspects of Disability (sec. 912 of the bill)

At a time when several major aspects of the social security disability program are to be re-evaluated and potentially revised in the light of advances in medical and vocational diagnostic and therapeutic techniques, the committee believes it is desirable to assure that the Secretary has ready access to the advice and recommendations of medical and vocational professionals. Thus, the bill creates a temporary Advisory Council (which would expire on December 31, 1985) consisting of medical, psychological and vocational experts to provide the necessary advice and recommendations to the Secretary on disability standards, policies and procedures. To assure the input of appropriate professional and consumer organizations, the Council would be authorized to periodically convene a larger representative group and to set up temporary short-term task forces to examine particular specialized issues. Under the bill, the Council's recommendations to the Secretary would be communicated to the Congress in SSA's currently required annual report to the Congress on the status of the disability program.

Of most immediate concern to the committee is the participation of the council in the required review of the mental impairment listings. The bill provides that the Council must be appointed within 60 days after enactment to assure the timely participation of the Council in this review.

The committee believes that the Council can also productively contribute to the re-examination of a number of other critical issues in the program. Section 912, for example, specifically directs the Council to examine and provide recommendations with respect to the question of requiring the involvement of appropriate medical specialists services; i.e., how best to assure their availability and effective delivery to disabled persons. Moreover, it is expected that the Council will participate in the assessment of possible policy changes affecting medical aspects of the program, particularly any changes that might be considered with respect to the evaluation of pain. Because the Advisory Council will be considering issues concerning the delivery of vocational rehabilitation services, work evaluation and appropriate procedures and criteria for such services and activities, it is expected that among those chosen to be included on the council will be those with expertise in administering State and private non-profit vocational rehabilitation programs.

e. Qualifying experience for appointment of certain staff attorneys to administrative law judge positions (sec. 913 of the bill)

To qualify for an ALJ appointment, one must be an attorney with at least seven years of experience participating in formal cases at regulatory agencies, or in the preparation and trial of cases in courts of record, or in certain other legal work described in announcement. At least two of those years must be in the field of administrative law or in certain activities regarding hearings or the trial of court cases. At lease one year of qualifying experience must have been at the GS–14 level in the Federal service, or at a comparable level of difficulty and responsibility in other employment. The highest grade available for staff attorneys who assist social security ALJs is the GS–12 level. Social security ALJ appointments carry a lifetime tenure at a GS–15 level.

The committee shares the concerns repeatedly expressed by OPM and SSA about the difficulty of finding qualified candidates for social security ALJ positions. Staff attorneys who work with social security ALJs are readily familiar with the social security program and with adequate training represent a potential pool of candidates for ALJ positions.

Section 913 requires the Secretary to establish a sufficient number of attorney advisor positions at GS-13 or GS-14 levels to ensure adequate career advancement opportunity for attorneys employed by SSA, and to assign duties and responsibilities to enable individuals in these positions to achieve qualifying experience for an ALJ appointment. The committee notes that the Committee on Post Office and Civil Service has expressed support for this amendment.

4. SSI provisions

a. Extension of the section 1619 program for the SSI disabled who perform substantial gainful activity despite severe medical impairment (sec. 926 of the bill)

Section 926 extends for two and one-half years, through June 30, 1986, the temporary authority contained in section 1619 of the Social Security Act that provides for the continuation of SSI benefits and/or Medicaid for disabled recipients who are able to work despite the continuation of their impairments.

Section 926 also requires the dissemination of information about the section 1619 program to the disabled and staff of various agencies and organizations.

Prior to mid 1985, HHS would compile information on the characteristics of section 1619 recipients including health services usage, impairments, and other information intended to be used in making recommendations regarding the continuation and/or needed modification in section 1619.

Section 1619 was enacted as part of the Disability Amendments of 1980 and was intended to lessen the work disincentives for SSI disabled recipients who, under prior law, risked the loss of SSI and Medicaid when they increase their work effort and earnings in spite of the continuation of their disability.

Section 1619(a) of the SSI law provides that an individual who loses eligibility for SSI because he or she works and demonstrates the ability to perform SGA, but who continues to have a disabling impairment, may become eligible for special SSI benefits until their countable income reaches the SSI income disregard "breakeven point". People who receive the special SSI benefits continue to be eligible for Medicaid on the same basis as regular SSI recipients.

Under section 1619(b), an individual can continue to be eligible for Medicaid even if their earnings have taken them past the SSI income disregard "breakeven point." This special eligibility status, under which the individual is considered a blind or disabled individual receiving SSI benefits for purposes of Medicaid eligibility, applies as long as the individual: (1) continues to be blind or have a disabling impairment; (2) except for earnings, continues to meet all the other requirements for SSI eligibility; (3) would be seriously inhibited from continuing to work by the termination of eligibility for Medicaid services; and (4) has earnings that are not sufficient to provide a reasonable equivalent of the benefits (SSI, State supplementary payments, and Medicaid) which would be available if he or she did not have those earnings.

Section 1619 was enacted to be effective for three years with the expectation that information would be gathered regarding the characteristics of those who benefit from section 1619 and the impact of such a program on reducing the work disincentives for the disabled under the SSI disability program. The most recent information available to the Committee from the Social Security Administration shows that in December 1982, 287 SSI recipients were receiving benefits under the provisions of Section 1619(a) and 5,600 former SSI recipients were retaining eligibility for Medicaid under section 1619(b). Approximately one-half of section 1619 recipients are under age 30 compared to only 16 percent of all SSI disabled adult recipients.

The Administration has agreed to an extension of section 1619 with the understanding that more complete data will be collected and available by mid 1985 for further evaluation of the program. The Administration has agreed to collect data regarding the characteristics of the individuals benefiting from these provisions, the effects on work effort, and, in the case of continued Medicaid coverage, the types of health care services utilized and their costs. Some of the specific areas that should be studied are (1) the types of impairments of the affected individuals, (2) the types of income available to these individuals; earned and unearned; the movement of individuals from one eligibility status to another; the kinds of health services used and the offsets to costs due to employer-related health insurance and other third-party resources. It is recognized that the collection and analysis of these data require the participation and cooperation of the Social Security administration for matters involving eligibility, characteristics, and work incentives; the Health Care Financing Administration for matters relating to Medicaid costs and utilization; and the State agencies administering the Medicaid programs for providing Medicaid data in their files; and the Committee expects such cooperation.

This provision to continue the section 1619 program, also directs the Secretary of Health and Human Services and the Secretary of the Department of Education to develop and disseminate information and establish training programs for staff personnel, with respect to the potential availability of benefits and services for disabled individuals under the provisions of section 1619. At Committee hearings held in California and Washington, D.C. and from reports from the disabled and rehabilitation and social services agencies, the Committee found a lack of awareness or knowledge of the section 1619 program.

As stated in testimony at the hearings, "Getting information out to the disabled community is no simple task. It requires the best effort of the Social Security Administration and the cooperative efforts of disability organizations, rehabilitation agencies, and other groups concerned with disability." However, as was also stated in hearings by a disabled individual, who did not utilize the option available under section 1619 because the District office staff of the Social Security Administration did not inform her about section 1619. " In order for SSI recipients like me to use these work incentive options, we need to be aware of how they can help us attain our employment goals without jeopardizing our health and wellbeing."

The provision provides that the Social Security Administration would be responsible for training programs for their staff in the District offices. The Social Security Administration would also be responsible for making a concerted effort to inform SSI disability applicants and recipients about the provisions of Section 1619. The amendment also mandates that the Department of Education, intended to be carried out primarily through the Rehabilitation Services Administration to also be involved in getting information out to the State Vocational Rehabilitation agencies. In addition, working with and through such agencies, the information is also to be made available to the other public and private rehabilitation and social service agencies in the States and to the various organizations of and representing the disabled.

The section 1619 program is intended to be a tool which can be used by those agencies and organizations responsible for enabling the disabled to improve their capabilities to increase their level of self support, to live independently or to work in a sheltered environment. Therefore, the committee is concerned that unless there is a greatly increased effort to get information out to a broad range of individuals and organizations that many disabled individuals will not be made aware of this attempt by Congress to eliminate the work disincentives for those disabled who are able to work in spite of their impairment.

In a related matter, the Committee is concerned that the Administration is counting toward the "trial work period" any month in which the disabled is earning over $75 a month in a sheltered workshop. The Committee feels that the trial work period is to be used to, in effect, test the individuals ability to be eventually employed in a sheltered work shop should not be counted toward the "trial work period" months.

At the hearing held by the Subcommittee on Public Assistance and Unemployment Compensation regarding the extension of the section 1619 program, the following case examples were presented as to the impact of the section 1619 program:

> In order for this committee to realize the impact of section 1619, a description of two cases should provide you with information that will, hopefully, assist in your decision. The first is a 26 year old woman who is a quadriplegic and requires an attendant to assist with her personal care and home care needs such as bathing, dressing, grooming, cooking, shopping and other needs. Vocational rehabilitation helped her complete a college program, providing funds for training and for attendant care. After graduating from college, she obtained full time employment as a computer operator with earnings of $650 a month. Although she briefly received attendant care under a State medical program, she eventually was told she must either quit working or lose her eligibility. Since she was unable to pay this herself, she decided to quit working.
>
> The second case is a personal friend on SSI who has overcome great barriers with his disability. He is a quadriplegic who has no use of his legs, right arm and limited mobility with his left arm. He obtained his Bachelor's degree in 1975 with assistance from the Vocational Rehabilitation Program. He then moved to Minnesota to continue with graduate school. Since no Medicaid Title 19 was available to assist with Attendant Care costs, he was forced into institutional care. In 1978, he was able to move out into the community of Minnesota due to the Attendant Care Program funded through the Federal and State Governments.
>
> While finishing his education, he began full time work for a Rehabilitation Center, but after the nine month Trial Work Period, he would lose SSI status and, therefore, eligibility for Medicaid Title XIX and Social Services Title XX which paid for his Attendant Care. Ultimately, he had to quit an excellent position at the conclusion of his Trial Work Period or be forced to return to a life of dependency and institutional care. The cost of such care far exceeds the cost of continuing to live independently in the community with partial benefits.
>
> Passage of the 1980 Social Security Disability Amendment, which included the provisions in Section 1619, changed the picture dramatically for these two individuals.

In 1981, my friend was able to obtain employment at another Rehabilitation Center in Minneapolis. He has retained Medicaid Title XIX and Social Services Title XX, and receives some SSI payments which make it possible to pay the additional expenses of living independently.

Today, he holds a new position with a private non-profit consulting firm that provides technical assistance on disability awareness to corporations and businesses in the private sector. The firm sponsors seminars that show supervisors and management how to work and communicate with disabled employees, thus, creating increased employment opportunities for persons with disabilities.

If SSI Special Benefits Amendment (Section 1619) is not continued, he will again be forced to quit his job in order to avoid institutional care, since he cannot afford the cost of attendant services without public assistance while engaged in employment.

b. SSI disability program work evaluation and rehabilitation study

Section 927 would require the Advisory Council on the Medical Aspects of Disability to also study the following issues related to the SSI Disability program:

> Consideration of alternative approaches to the use of work evaluation related to determination of eligibility for SSI disability benefit including: criteria for referral to work evaluation; relationship to rehabilitation potential and training; and appropriateness of providing stipends during extended work evaluation; and
>
> Reexamining the definition of a successful rehabilitation of an SSI disabled recipient to include the ability of the severely disabled to work in a sheltered environment and live independently.

Work evaluation for purpose of the study would include determining an individual's: work activity capabilities; work activity limitations; rehabilitation potential; ability of the mentally impaired to cope with a competitive work environment; and needed modifications in the work setting to enable the individual to work.

Section 927 of the bill would require the Advisory Council on the Medical Aspects of Disability to consider alternative approaches to the use of work evaluation related to the SSI disability program. Such consideration by the Council should include examining proposals presented to the Committee on Ways and Means by various individuals and organizations with expertise in the area of work evaluation and rehabilitation.

The SSI program for the disabled grew out of the formerly State administered program for the disabled and was not an offshoot of the Social Security Disability Insurance program. Under the pre-SSI program the definition of disability was set by each State under some rather general Federal statutory and regulatory language.

While there is a common definition for disability for the Disability Insurance program and the SSI program, there are a number of very significant differences between the two programs and the characteristics of the recipients of disability insurance and SSI disability recipients. These differences are critical when evaluating an individual's potential for employment and when determining the approach which should be taken both in determining eligibility for disability benefits and the approach to rehabilitation activities for such recipients. In addition, it needs to be recognized that Congress has defined a unique function for the SSI disability under the section 1619 program by providing ongoing income support and medical services under Medicaid for those disabled who have disabling impairments but who wish to have some level of employment in spite of their impairment.

The following chart compares some selected characteristics of the two programs and of the recipients of benefits under the two programs.

Comparison of Selected Characteristics of the SSI Disability Program and the Social Security Disability Program and a Comparison of Selected Characteristics of Recipients of Disability and SSI Disability Benefits

Social Security Disability Insurance	SSI Disability Program
A. NON-DISABILITY BASIS FOR ELIGIBILITY	
A. Disability Insurance provides benefits for workers who are "insured for disability" and their dependents.	A. Eligibility for an the amount of SSI benefits for a disabled or blind individual is not related to whether the individual has earned social security coverage or to the level of an individual's previous earnings. Cash assistance for the disabled and blind under SSI is provided only to those in addition to meeting the disability criteria have income and resources low enough to meet the Federal plus state supplementation (if any) income eligibility standards. While approximately 34 percent of the disabled receiving SSI disability benefits also receive DI benefits, only one-third of those or 12 percent are DI recipients on the basis of their own work history.
B. IMPACT OF EARNINGS BY RECIPIENTS ON AMOUNTS OF BENEFITS	
B. Earnings by DI recipients below the SGA earnings test level does not reduce the amount of DI benefits paid to the recipient.	B. SSI recipients have a $1 reduction in SSI benefits for every $2 in earnings in excess of $65 a month ($85 a month if no other income).
C. MAJOR DISABLING DIAGNOSIS	
C. Approximately 12 percent of the DI recipients are eligible of the basis of mental impairments; circulatory disorders account for 29 percent of the disabling impairment; and skeletal-muscular impairments account for 19 percent.	C. Approximately 40 percent of the SSI disabled are eligible on the basis of mental impairments. Approximately 20 percent are on the basis of circulatory disorders.

COMPARISON OF SELECTED CHARACTERISTICS OF THE SSI DISABILITY PROGRAM AND THE SOCIAL SECURITY DISABILITY PROGRAM AND A COMPARISON OF SELECTED CHARACTERISTICS OF RECIPIENTS OF DISABILITY AND SSI DISABILITY BENEFITS—CONTINUED

Social Security Disability Insurance	SSI Disability Program
D. AGE OF RECIPIENTS	
D. 7. percent are under age 30 and 66 percent of the DI population in ages 50 through 64 years of age.	D. 24 percent are under age 30 of the SSI disabled population ages 18-64 and 66 percent are ages 50-64 of the SSI disabled population ages 18-64.
E. SEX OF RECIPIENTS	
E. 70 percent male and 30 percent female.	E. 40 percent male and 60 percent female.

At the August 3rd hearing of the Subcommittee on Public Assistance and Unemployment Compensation, testimony was presented on behalf of the State of Michigan's Interagency Task Force on Disability by the Director of the Michigan Department of Mental Health. The Michigan Task Force, which consists of professional staff from the State Disability Determination Service, the State vocational rehabilitation service agency, the State department of Mental Health, Department of Social Services and other state agencies made recommendations based on a broad view of the role of Federal and state government's responsibilities as related to the disabled. In describing the proposed Michigan model, as to the recommended use to be made of work evaluation, the Task Force representative contended that long term cost savings will accrue to the Federal government and to States through the use of work evaluations and vocational rehabilitation in selected cases.

The testimony stated that:

> The relationship between multiple impairments and work ability or the relationship between residual capacity and work ability should be reliably documented. This documentation should involve the application of accepted techniques by a trained counselor who can become personally familiar with the claimant. This vocational documentation should become a part of the objective information which is reviewed in deciding whether disability benefits should be awarded. In this way, and only in this way, can ALJ's and disability examiners render uniform, reliable decisions based on objective assessments of a whole person—including equally-weighted medical and functional documentation

In directing the Advisory council to consider alternative approaches to work evaluation, section 927 defines work evaluation as follows:

> For purposes of this section, "work evaluation" includes (with respect to any individual) a determination of (a) such individual's (b) the work activities or types of work activity for which such individual's skills are insufficient or inadequate, (c) the work activities or types of work activity for which such individual might potentially be trained or rehabilitated, (d) the length of time for which such individual is capable of sustaining work (including, in the case of the mentally impaired, the ability to cope with the stress of competitive work), and (e) any modifications which may be necessary, in work activities for which such individual might be trained or rehabilitated, in order to enable him or her to perform such activities.

The reason that such an approach is recommended, especially as related to the SSI program is that most SSI applicants have had a very tenuous or non-existent connection to the work force. Therefore, if work evaluation is used only to determine eligibility for income assistance, the result could be to deny the individual the opportunity to gain access to those rehabilitation services which can enable an individual to lessen his or her dependency. On the other hand, if work evaluation is not used to accurately gauge, to the extent possible, the individual's limitations on being able to work at a substantially gainful wage level then the individual may be denied that financial assistance to which he or she is entitled and which is reflective of his or her very limited capacity to be self-sufficient.

This approach to work evaluation is illustrated in the following excerpt from the State of Michigan testimony:

> In the model, I propose all individuals who pass through the screening criteria would be determined "presumptively disabled" and would be granted SSI benefits for up to six months, during which time additional vocational information would be acquired. These presumptive beneficiaries would be referred to state Vocational Rehabilitation agencies for a work evaluation to determine their potential for either gainful employment or for the development of skills needed for successful sheltered employment.
>
> Results for work evaluations would be transmitted to examiners within the State DDS to be used in their final determinations of disability. If, based on comprehensive work evaluations, the claimant is found capable of SGA, the DDS would deny the individual as non-disabled. If the person is found to have no potential for SGA, and it is determined that further efforts at rehabilitation would not be effective (due to impairment), the case would be approved for SSI and SSDI benefits. In such cases, involvement in a sheltered workshop on an ongoing basis might be appropriate, with benefit levels reduced by the amount of sheltered workshop income. Finally, if the person is found to be potentially employable, SSI benefits would be granted during the person's progression (through rehabilitation) to more independent work settings. This latter possibility, involving training and rehabilitation, would vary

> in length depending on individual competencies. At all points in a work rehabilitation plan, disability benefits would be reduced by the amount of income earned, case management responsibility would be vested in the rehabilitation agency (with DDS diarying claimant progress).

The amendment suggests the evaluation of the concept of "stipends" to be provided to those in the work evaluation process. The purpose here is to recognize that those individuals with such borderline ability to be self supporting must have some means of subsistence level of income while in an extended work evaluation.

Section 927 also requires the Advisory Council to examine the criteria for assessing whether a recipient of SSI disability benefits will benefit from rehabilitation services. Specifically, the amendment provides that such an examination will consider whether such criteria should include not only whether an individual will be able to engage in substantial gainful activity but also whether such services can be expected to improve the individual's functioning so that he or she will be able to live independently or work in a sheltered environment.

Unlike the Disability Insurance program, earned income below the Substantial Gainful Activity earnings test of $300 a month received by SSI disability recipients does result in a savings to the SSI program. SSI benefits are reduced $1 for every $2 of earnings after the initial disregard of the first $85 a month for individuals with no other income. Therefore, rehabilitation services and training will have a savings to the SSI program even if the earnings of an SSI disability recipient does not reach the SGA earnings test of $300 a month.

In addition, at the income level provided under the SSI program even an additional small increment of income from sheltered employment can make a significant difference between marginal subsistence and some degree of independence, improved quality of life, and self-esteem which such earnings can provide.

c. SSI conforming amendments

Included in the bill as reported by the Committee are provisions to make generally the same changes in the SSI statute (Title XVI of the Social Security Act) as are made in the Disability Insurance program under Title II of the Social Security Act. The provisions also ensure applicability to the SSI Disability program of certain temporary provisions in Title IX affecting the Disability Insurance program. These include, for example, making applicable to the SSI program required studies related to pain and the moratorium in the reviews of the mentally impaired.

5. Effective date (sec. 914 of the bill)

Except as otherwise provided, these provisions of the bill would apply with respect to cases involving only disability determinations pending in HHS or in court on or after the date of enactment.

TITLE X—MEDICARE BUDGET RECONCILIATION AMENDMENTS

A. Payment- and Coverage-Related Changes

1. Payment for outpatient diagnostic laboratory tests (sec. 1001 of the bill)

Present Law

Under present law, outpatient diagnostic laboratory services are reimbursed on the basis of reasonable charges when furnished by an independent laboratory or by a physician. Payment for such services to hospital outpatients is on the basis of reasonable cost. These laboratory services are covered under part B of the medicare program; thus, the beneficiary is subject to the part B deductible and coinsurance requirements.

Explanation of Provision

The bill would require the establishment of a fee schedule for all laboratory services except those for hospital inpatients. Payment would be based on the fee schedule unless the actual charge is lower. The schedule may initially be established on a carrier or regional basis; however, within three years after the date of enactment the Secretary would be required to develop and implement a national fee schedule.

The Secretary would be given the discretion to provide for adjustments to the national fee schedule to account for wage variations if the Secretary determines that variations in wages between different areas of the country significantly affect the cost of providing laboratory services and that an adjustment is appropriate.

The initial payment level for the fee schedule would be established at 60% of prevailing charges for the fee screen year beginning July 1, 1984. The Secretary would be required to adjust the fee schedules annually to reflect changes in the Consumer Price Index for all Urban Consumers (U.S. city average) and could make additional adjustments that the Secretary determines are justified by technological changes.

All clinical laboratories would be required to bill the medicare program directly, rather than billing the physician who ordered the tests (laboratories performing tests "under arrangement" with a hospital could continue to bill the hospital for hospital outpatients). Physicians would be permitted to bill for clinical laboratory services only if the physician (or another physician with whom the physician shares his practice) personally performed or supervised the performance of the test.

Independent laboratories would be required to accept medicare assignment. Hospital laboratories would have a similar obligation under the hospital's medicare participation agreement not to charge a hospital outpatient for whom the hospital's laboratory performs diagnostic tests. With respect to tests performed for nonhospital patients, the bill would require the hospital to accept assignment. Reimbursement for these assigned claims would be at 100% of the fee schedule and applicable deductible and coinsurance amounts would be waived.

Where a physician bills for laboratory services that he personally performs or supervises, the physician may accept or not accept medicare assignment on a claim by claim basis. When the physician agrees to accept assignment, medicare reimbursement would be at 100% of the fee schedule amount, and the coinsurance and any applicable deductible would not apply. When the physician chooses not to accept assignment, medicare reimbursement would be 80% of the fee schedule amount and applicable coinsurance and deductible amounts would apply.

The bill provides for the payment of a nominal fee for the drawing of patient specimens. However, this payment may be made only once per encounter to either the physician or the clinical lab, whomever draws the specimen. The committee intends that the Secretary would determine an appropriate payment amount for these services. The payment may vary under specified circumstances if the Secretary determines differences in costs make such an adjustment appropriate.

Current law authorizes the Secretary, for certain items and services, to establish medicare reasonable charge levels at the lowest charge levels at which the item or service is widely and consistently available in a locality. The committee believes that these provisions of law would no longer be applicable with respect to clinical laboratory services once the fee schedule reimbursement system is implemented.

The Secretary would be directed to simplify current billing requirements for laboratory services. Such simplification may include eliminating requirements that a patient diagnosis appear on a clinical laboratory bill, mechanisms to ensure prompt payment, minimizing the amount of information required for claims processing and facilitating bulk or periodic billing for multiple beneficiaries.

Effective Date

The provision would be effective for services furnished on or after July 1, 1984.

2. Coverage of administration of hepatitis B vaccine (sec. 1002 of the bill and sec. 1861 of the Act)

Present Law

Current law prohibits medicare coverage of immunizations and vaccines except in the case of pneumoccocal vaccine, which the Congress specifically covered in 1980.

Explanation of Provision

The bill would provide medicare coverage of hepatitis B vaccine for medicare beneficiaries when the vaccine is administered in a hospital or renal dialysis facility. The applicable medicare part B deductible and coinsurance is waived.

The committee intends that the Secretary limit those eligible to receive the hepatitis B vaccinations to those at high risk of infection. The committee anticipates that the Secretary will develop coverage guidelines using available information to define those groups at high risk of contracting this disease, using specifically, but not necessarily exclusively, the information developed by the Centers for Disease Control (CDC).

The committee understands that one of the groups at high risk, identified by the CDC, is the medicare end-stage renal disease population. Medicare beneficiaries suffering from end-stage renal disease are particularly susceptible to hepatitis B and are currently monitored by testing, frequently on a monthly basis, for the virus. The committee believes that this population should be covered by this provision.

The committee has given the Secretary the flexibility to develop a payment method that may be different from the usual medicare reimbursement rules. In developing such a payment system, however, the committee believes that it should be entirely separate from the composite rate reimbursement system for renal dialysis services. Furthermore, the committee believes that any payment system should provide a payment amount which reasonably reflects the cost of efficiently providing and administering the vaccine.

Effective Date

The provision would be effective for services furnished on or after July 1, 1984.

3. Pacemaker reimbursement review and reform (sec. 1003 of the bill)

Present Law

Under present law, the costs of inpatient hospital services with respect to the implantation of pacemakers, including the costs of the device, are subject to the new diagnosis-related group (DRG) prospective payment system. However, the costs of physicians' services for implantation and post-implantation monitoring of the devices are reimbursed under part B and are not subject to the new system.

Explanation of Provision

It is anticipated that the new DRG prospective payment system will significantly reduce the costs of hospital inpatient services with respect to pacemaker implantation. However, concerns remain with regard to the frequency of subsequent monitoring, physicians' fees, and warranties with respect to the devices.

Concerns have been raised with respect to the frequency of transtelephonic monitoring of implanted pacemakers. The bill would require the Secretary of Health and Human Services to issue, before October 1, 1984, revisions to the current guidelines on the frequency of transtelephonic monitoring procedures which are reasonable and necessary. It is anticipated that the Secretary will have had time to review a number of analyses which are currently being conducted on this subject before that date.

The bill provides that, if the Secretary has failed to issue such revised guidelines before October 1, 1984, payments under medicare will be limited to those specified in the legislation. The bill limits the frequency of monitoring procedures to no more than: (1) weekly during the first month of implantation, (2) once every two months during the period representing 80 percent of the estimated life of the device, and (3) monthly thereafter. The Committee wishes to make it clear that the application of these restrictions would be limited to single-chamber cardiac pacemakers powered by lithium batteries. In addition, the bill provides that the limitations would not apply where special medical factors (including possible evidence of pacemaker malfunction) justify more frequent monitoring.

The bill requires the Secretary to report to the Congress on the appropriateness of the current rate of physician reimbursement for services associated with implantation and replacement of pacemakers and pacemaker leads. The Secretary would be required to take into account the amounts recognized as reasonable with respect to the procedures and the time and difficulty of the procedures compared to those when such rates were first established. The Committee intends that the Secretary shall take into consideration improvements in efficiency of pacemaker implants in reviewing the appropriateness of payments to physicians. In making such a report, the Secretary would be required to take into coinsideration the reduction of such recognized rates by 20 percent. The report would be due on October 1, 1984.

Finally, the bill would require the Secretary, through the Food and Drug Administration, to provide a registry of all cardiac pacemaker devices and leads for which payment may be made under medicare. The registry would include the manufacturer, model, serial number, and manufacturer's price, the name of the recipient, the date and geographic location of the implantation or removal, and the name of the physician, hospital or other provider. The registry would be required to include any express or implied warranties associated with the device and any other information which the Secretary deemed appropriate.

The purpose of the registry would be to assist the Secretary in determining when medicare payments may properly be made, in determining when inspection by the FDA may be necessary for purposes of review and testing for malfunctions of pacemakers, and in carrying out such other studies as the Secretary may determine appropriate. The Secretary would be specifically prohibited from identifying any recipient of a pacemaker by name.

In any case where the Secretary had reason to believe that replacement of a pacemaker was related to its malfunction, the Secretary would be permitted to require the testing of such device by the FDA or be present at the testing by the manufacturer.

Effective Date

The provision would be effective upon enactment.

4. Payment for debridement of mycotic toenails (sec. 1004 of the bill)

Present Law

Routine foot care is not covered under the medicare program; however, medicare does allow reimbursement to physicians for debridement of mycotic toenails (toenails with a fungal infection) which cannot be performed by a nonprofessional.

There has been considerable concern regarding the frequency with which this procedure is taking place. The Health and Human Services Inspector General conducted a review in Virginia and concluded that this benefit was being abused, because the procedure was being performed more frequently than necessary and was being performed on patients (particularly nursing home patients) who did not require professional care.

Explanation of Provision

The bill would require the Secretary, by regulation, to deny coverage under the medicare program for debridement of mycotic toenails if performed more frequently than once every 60 days. Exceptions would be authorized if medical necessity were documented by the physician.

It is the intent of the provision to assure that payment will not be made for debridement performed more frequently than every 60 days; however, the committee is aware that the Secretary may wish to evaluate the practice further and may determine that a tighter standard is more appropriate. It is not the intent of this provision to prohibit the Secretary from establishing a standard which is more restrictive than that provided in the statute. The Secretary would not be prohibited from establishing a rule limiting payment to debridement performed less frequently than every 60 days (except as medically necessary).

Effective Date

The provision would be effective upon enactment.

5. Payments for costs of hospital-based mobile intensive care units (sec. 1005 of the bill)

Present Law

In general, ambulance services are reimbursed under medicare on a reasonable charge basis; if they are furnished by a hospital, they are reimbursed on a reasonable cost basis. However, such services are covered only if the patient is transported to the hospital or to another specified location. In addition, the patient is responsible for a coinsurance payment of 20 percent.

Mobile intensive care units (MICU's) are vehicles equipped with sophisticated advanced life support systems and staffed by paramedics trained to deal with life threatening emergencies. They also have portable telemetry equipment that allows them to remain in constant communication with a physician.

Several hospitals in New Jersey operate MICUs. They provide on-the-scene services but they do not transport the patient to the hospital. Rather, they operate in conjunction with community volunteer emergency vehicles which transport the patient to the hospital for no charge.

The State of New Jersey currently has a medicare waiver under which it operates a prospective payment system. To receive the waiver, the State was required to provide assurances to the Secretary of HHS that expenditures for medicare under the system would not exceed those which otherwise have been made.

Explanation of Provision

The bill provides that medicare would make payment to hospitals under part A for the operation of mobile intensive care units if certain conditions are met. The hospital must be located in a State which has a Statewide prospective payment system approved by HHS either under a demonstration waiver or under the new section 1886(c) programmatic waiver. Where the State has a demonstration waiver, the provision will apply unless the State notifies the Secretary of HHS within 30 days of the date of enactment of this bill that the State does not want the provision to apply. In the case of a section 1886(c) waiver, the State must notify the Secretary within such reasonable period as the Secretary may establish.

Finally, the State must provide satisfactory assurances that total medicare and medicaid payments to the hospitals covered under the State system will not exceed the total payments which would have been made. The committee intends that this provision be applied only under very limited circumstances. The case of New Jersey provides a special situation in which volunteer ambulances transport patients to hospitals. It is not the desire of the Congress through the medicare program to disrupt this community service. However, the committee anticipates that in most cases, medicare payments for ambulance and intensive care services will continue to be made subject to the same conditions and limitations as under present law.

Effective Date

The provision would be effective retroactivity to January 1, 1983.

6. Payment for physicians' services furnished to hospital inpatients (sec. 1006 of the bill). (This section is not a part of the committee amendment in the nature of a substitute. It will be offered as a separate committee amendment to the basic text of the bill under the rule request made by the Committee on Ways and Means to the Committee on Rules.)

Present Law

Under current law, medicare pays for physician services on the basis of medicare-determined "reasonable charges". Reasonable charges are the lesser of: (1) a physician's billed charge; (2) the customary charge made by an individual physician for a specific service; and (3) the prevailing level of charges made by all physicians for specific services in a geographic area. The customary and prevailing charges are updated annually (on July) to reflect changes in physician charging practices. Increases in the prevailing charge levels are limited by an economic index, which reflects changes in the physicians' practice costs and changes in general earnings levels.

Under current law, the medicare program provides for two alternative ways of paying for services provided to medicare beneficiaries: (1) the physician can bill the medicare beneficiary his usual fee, just as he would most other patients. The beneficiary is then responsible for obtaining the reimbursement from the medicare carrier. The beneficiary is responsible for the deductible amount (if not previously satisfied), the 20% coinsurance on the medicare-allowed charge, plus 100% of the physician's fee above the allowed charge. (2) The beneficiary may choose to assign his rights to pay ment to the physician who may agree to accept assignment. Under the "assignment of benefits" option, the physician agrees to accept the medicare determined reasonable charge as payment in full and is paid directly by the medicare carrier. The physician may bill the beneficiary only for the 20% coinsurance and any applicable deductible.

The medicare program currently allows physicians to decide whether or not to accept medicare assignment on a case-by-case basis. There has been a significant decline in physician willingness to accept assignment over the last 15 years, although in the last 2–3 years there has been a slight increase. Recent data indicates that approximately 53 percent of medicare claims are assigned, amounting to 54 percent of charges.

Explanation of Provision

The bill as reported provides for a 12-month freeze on the economic index used to limit prevailing charges. The freeze would be applicable only to charges for physician services provided to hospital inpatients. The levels would be frozen at June 30, 1984 levels from July 1, 1984, until June 30, 1985 and there would be no provision for a catch-up in subsequent years.

Physicians would be required to accept medicare assignment for all services provided to medicare hospital inpatients. This mandatory assignment provision would remain in effect until six months after the Congress receives the Secretary's report and recommendation on the advisability and feasibility of including payments for inpatient physician services in the DRG prospective payment legislation. Under the bill, the report is due on July 1, 1985.

The medicare provider agreements that all hospitals receiving medicare reimbursement are required to have would be modified. The new provider agreement would obligate the hospital to obtain signed agreements from each doctor on its medical staff (courtesy or otherwise), who provides inpatient services in the hospital, stating that the physician agrees to accept assignment for any medicare beneficiary that he treats as an inpatient of that hospital. The committee expects that the Secretary will specify the form and manner in which hospitals will be required to satisfy this requirement.

Although the hospital would be required to obtain the assignment agreement from each physician providing services to inpatients of the hospital, the hospital would not be responsible for enforcing the assignment agreement. The current law provisions relating to physicians who fail to honor their assignment agreement would apply and enforcement would be through the usual administrative and judicial channels, except that the hospital would be expected to notify appropriate authorities if it became aware that a physician had failed to honor his assignment agreement.

The committee's reported bill includes the mandatory assignment requirement because of concern over the possibility that in its absence beneficiaries would end up bearing at least some part of the burden of the cost saving for the medicare program resulting from the prevailing fee freeze. The requirement that hospitals obtain assignment agreements from their medical staffs was included to assure that no beneficiary would be left with the responsibility for the entire bill of a physician who refused to accept assignment after agreeing to treat a medicare patient.

Although physicians have had the option, since the beginning of medicare, of deciding on a case by case basis whether to accept or refuse medicare assignment, there is ample precedent for an arrangement under which medicare program payment is required to be treated as payment in full (except for deductible and coinsurance amounts). This is the basis on which about three-fourths of medicare payments are made today and have been made since the program began.

Hospitals and other providers of services have always operated under a medicare participation agreement which obligates them not to impose additional charges on the beneficiary. In the interest of protecting the beneficiary against increased out of pocket expense, the committee's reported bill adopts a similar approach with respect to inpatient physician services only. This provision would be in effect for a temporary period only. At the conclusion of that period, the Congress will have available to it the Secretary's report and recommendations mentioned above, as a basis for its consideration of future payment arrangements for physicians' services to hospital inpatients.

Effective Date

The provision would be effective for services furnished on or after July 1, 1984.

B. Miscellaneous Administrative Changes

1. Presidential appointment of and pay level for the administrator of the Health Care Financing Administration (sec. 1021 of the bill and sec. 1117 of the Act)

Present Law

By law, the Administrator of the Health Care Financing Administration (HCFA) is in the Senior Executive Service and is appointed by the Secretary of the Department of Health and Human Services.

Explanation of Provision

The bill provides for the appointment of the Administrator of HCFA by the President with the advice and consent of the Senate. The position and pay of the Administrator would be increased to Level IV of the Executive Schedule.

Effective Date

The provision would be effective with respect to appointments to the position made after enactment.

2. Permitting limited provider representation on peer review organizations (sec. 1022 of the bill and sec. 1153 of the Act)

Present Law

Under current law, no health care facility such as a hospital may be a peer review organization (except by specific rules of delegated review). The law specifically prohibits the Secretary of HHS from contracting with an entity which is, or is affiliated with (through management, ownership or common control), a health care facility. The Secretary, by regulation, has interpreted this to mean that a peer review organization (PRO) may not have a governing body which has a member or individual who is a governing body member, officer, or managing employee of a health care facility.

Explanation of Provision

It is common among professional standards review organizations (PSRO's) (which are being phased out and replaced by PRO's) for one or two of the hospital administrators to sit on the PSRO board. The regulation could have the effect of prohibiting any physician or other person who is on the board of, or has certain administrative responsibilities in, a hospital from serving on the board of a PRO.

The bill provides for limited representation of providers on PRO's. In the case of a PRO with a governing body of 15 or fewer member, one such member may be a governing body member, officer, or managing employee of a health care facility; and in the case of a PRO with a governing body of more than 15 members, no more than two such members may be a governing body member, officer, or managing employee of a health care facility. The Secretary would be prohibited from contracting with any entity which did not meet these requirements.

Effective Date.

The provision would take effect upon enactment.

3. Access to home health services (sec. 1023 of the bill and secs. 1814 and 1835 of the Act)

Present Law

(a) Current law requires a physician to certify as to a patient's health needs and establish a plan-of-care before the beneficiary can qualify for home health benefits. The Secretary is directed, however, to prescribe regulations to disqualify physicians from carrying out these functions for patients of any agency in which they have a significant ownership interest or a significant financial or contractual relationship.

(b) Current regulations, specifying which physicians are disqualified from carrying out the certification and plan-of-care functions for patients of a home health agency, include physicians who are uncompensated officers or directors of incorporated agencies, even though they have no financial interest in its operation.

Explanation of Provision

(a) The bill would permit a physician who has financial interest in an agency which is a sole community home health agency to carry out the certification and plan-of-care functions for patients who will receive services from the agency. Existing regulations, which were intended to prevent potential conflicts of interest, have created a serious problem for the relatively few patients whose physicians have an interest in the only agency in the area. These patients have been unable to qualify for home health benefits unless they changed physicians.

The Secretary would be required to promulgate regulations defining "sole community home health agencies" for purposes of this provision.

(b) The bill would delete from the list of disqualified physicians uncompensated officers or directors of incorporated agencies. These physicians do not stand to gain or lose from referrals to the agency.

Effective Date

(a) The provision would be effective upon enactment.

(b) The provision would be effective for certifications and plans established or reviewed on or after the date of enactment.

4. Repeal of special tuberculosis treatment requirements (sec. 1024 of the bill and secs. 1814 and 1866 of the Act)

Present Law

Present law contains a number of provisions intended to assure that institutional services provided to medicare and medicaid patients suffering from tuberculosis are not custodial in nature and that such treatment can reasonably be expected to improve the patient's condition or render the condition noncommunicable.

Explanation of Provision

The bill repeals the special provisions. Advances in the active treatment of tuberculosis make such safeguards against paying for custodial care for tuberculosis patients unnecessary. The bill also eliminates the special provider category in present law for tuberculosis hospitals in the medicare and medicaid programs.

Effective Date

The provisions would take effect upon enactment.

5. Indirect payment of supplementary medical insurance benefits (sec. 1025 of the bill and sec. 1842 of the Act)

Present Law

Current law does not, in general, permit payments to be made to anyone other than a beneficiary or an entity providing services.

Explanation of Provision

The bill would permit part B payments to be made to a health benefits plan, if the beneficiary agrees, and if the physician or other supplier accepts the plan's payment as payment in full.

Effective Date

The provision would take effect upon enactment.

6. Including podiatrists in definition of "physician" for outpatient physical therapy services and including podiatrists and dentists in definition of "physician" for outpatient ambulatory surgery (sec. 1026 of the bill and secs. 1861 and 1832 of the Act)

Present Law

(a) The services of a podiatrist (when acting with the scope of his practice under State law) are covered under the existing medicare program; also, a podiatrist is generally defined as a "physician" for certain physician certification purposes. However, a podiatrist is not a "physician" for purposes of the outpatient physical therapy benefit under medicare. Outpatient physical therapy services are covered only if the patient is "under the care of a physician." For this purpose the law defines a physician as an M.D. or D.O. (excluding podiatrists).

A podiatrist (acting within the scope of his practice) is a "physician" for certifying the need for care, including the need for services such as physical therapy in the provider setting but is not a "physician" for purposes of outpatient physical therapy.

(b) A dentist is a "physician" for covered dental services. However, for outpatient ambulatory surgery in a surgeon's office, medicare does not define either a podiatrist or a dentist as a "physician."

Medicare provides coverage under preferential terms for certain outpatient ambulatory surgery (a) in an ambulatory surgical center, and (b) in a surgeon's office. Podiatrists and dentists are physicians for purposes of surgery in an ambulatory surgical center. (Certain dental surgery is covered despite the general exclusion of dental care.)

Certain technical problems have prevented issuance of regulations under which surgery in a surgeon's office could be covered. If the provision were to be implemented, services of both dentists and podiatrists would be excluded because they are not defined as "physicians" for this purpose.

Explanation of Provision

(a) The bill would define a podiatrist (when acting within the scope of his practice) as a "physician" for purposes of the requirement that an outpatient physical therapy patient must be under the care of a physician.

(b) The bill would include dentists and podiatrists among the "physicians" whose services are covered under the provisions relating to ambulatory surgery in a surgeon's office.

Effective Date

The provision would be effective for services furnished on or after the date of enactment.

7. Establishment by physical therapists of plans for physical therapy (sec. 1027 of the bill and secs. 1861 and 1835 of the Act)

Present Law

Under current law, medicare payment for outpatient physical therapy services furnished to a beneficiary may be made only if a plan for furnishing such services has been established by a physician and is reviewed periodically by the physician.

In actual practice, physicians frequently rely on the physicial therapists to recommend a plan of treatment for physical therapy services. However, the physician actually prescribes the services for a patient and routinely signs and reviews the plan of treatment recommended by the physical therapist.

Explanation of Provision

The bill would allow either the physical therapist or the physician to establish the plan of treatment. The physician would still be required to periodically review the plan as under existing law. This would make the establishment and review of the plan of treatment for physical therapy the same as that permitted under the existing medicare speech therapy benefit.

Effective Date

The provision would be effective with respect to plans of care established on or after the date of enactment.

8. Access to records to subcontractors (sec. 1028 of the bill and sec. 1861 of the Act)

Present Law

Under P.L. 96-499 (The Omnibus Reconciliation Act of 1980), in any agreement between a medicare provider and a subcontractor valued at $10,000 or more, the Secretary or Comptroller General must have access to the subcontractors' records.

Explanation of Provision

The bill increases the amount to a $50,000 minimum, thus alleviating a paperwork burden for small contractors.

Effective Date

The provision would be effective with respect to contracts entered into with subcontractors on or after date of enactment.

9. Medicare recovery against certain third parties (sec. 1029 of the bill and sec. 1862 of the Act)

Present Law

Under the current law, the medicare program may make benefit payments for services for which other third party insurance programs (e.g., worker's compensation, auto or liability insurance, and employer health plans) are ultimately liable for some or all of the costs. However, the Secretary does not now have the right of subrogation, to become a party to claims against other liable parties or to recover directly from such parties.

Explanation of Provision

The bill establishes the statutory right of medicare to recover directly from a liable third party, if the beneficiary himself does not do so, and to pay a beneficiary, or on the beneficiary's behalf pending recovery where such third party is not expected to pay promptly. The bill would also permit the Secretary to recover directly from the third party whether or not the beneficiary brings suit to recover and subrogate to the United States the right of the individual or anyone else to payment from the third party. These provisions are intended to improve the ability of the medicare program to obtain reimbursement to which it is entitled by law. The bill would not permit medicare to bring an action against a beneficiary who had already been paid by the third party. Rather, the normal medicare rules with respect to collection of overpayments would apply.

10. Use of accrediting organizations for certain entities furnishing services (sec. 1030 of the bill and sec. 1865 of the Act)

Present Law

Under current law, the Secretary has authority to rely on certain accrediting organizations in determining whether hospitals, skilled nursing facilities, home health agencies, ambulatory surgical centers and hospice programs meet medicare requirements.

Explanation of Provision

The bill extends the Secretary's authority to permit the Secretary to rely on such organizations in determining whether rural health clinics, laboratories, clinics, rehabilitation agencies, including outpatient rehabilitation facilities, psychiatric hospitals and public health agencies meet medicare requirements (and clarifies the Secretary's authority with respect to ambulatory surgical centers). The committee believes that the standards of an accrediting organizations should be at least equivalent to those of the Secretary, and such organization should have a satisfactory record of application of such standards.

Effective Date

The provision would take effect upon enactment.

11. Confidentiality of accreditation surveys (sec. 1031 of the bill and sec. 1865 of the Act)

Present Law

Current law contains certain disclosure safeguards relating to survey information used by the Secretary in connection with the hospital certification process under medicare. However, the law only specifically refers to surveys conducted by the Joint Commission on the Accreditation of Hospitals (JCAH).

Explanation of Provision

The bill extends the same disclosure protections given JCAH survey information to similar survey information provided to the Secretary by the American Osteopathic Association or other national accreditation organizations.

Effective Date

The provision would take effect upon enactment.

12. Thirty-day coverage for services furnished by a home health agency whose agreement has been terminated (sec. 1032 of the bill and sec. 1866 of the Act)

Present Law

Under current law, if medicare participation of a home health agency is terminated, the Secretary is required to continue to pay for services provided to a beneficiary until the end of the calendar year in which the termination took place. This requirement is only applicable to services provided under an individual plan of care established prior to the termination of the agency.

Explanation of Provision

The bill changes from the end of the calendar year to 30 days after termination, the ending of coverage for services provided under a plan established prior to the termination date of the participation agreement. The bill brings provisions for home health agencies into conformity with provisions for hospitals and skilled nursing facilities.

Effective Date

The provision would apply with respect to terminations whose effective date falls after 60 days after the date of enactment.

13. Termination of agreements with institutions and entities where owners or certain other individuals have been convicted of certain offenses (sec. 1033 of the bill and sec. 1866 of the Act)

Present Law

Current law authorizes the Secretary to bar from participation in medicare (and to direct State agencies to bar from medicaid) a person convicted of program-related criminal offenses.

Explanation of Provision

The bill extends the Secretary's authority to exclude from medicare participation (and to direct State agencies to exclude from medicaid participation) any entity in which ownership or controlling interest is held by a person convicted of program related criminal offenses, or in which an officer, director, agent or managing employee was convicted of such criminal offense.

Effective Date

The provision would take effect upon enactment.

14. Elimination of Health Insurance Benefits Advisory Council (sec. 1034 of the bill and sec. 1867 of the Act)

Present Law

Section 1867 of Social Security Act provides for a 19 member panel of health experts (the Health Benefits Advisory Council or HIBAC) appointed by the Secretary to advise on matters of general policy with respect to the medicare program.

Explanation of Provision

The bill repeals Section 1867 of the Social Security Act. HIBAC was very active in the early years of the medicare program when regulations were first promulgated. As the Federal Government gained experience in administering the medicare program, the Council's advisory functions with respect to regulations became less important. With passage of the Social Security Amendments of

1972, Public Law 92-603, the Council's authority to review regulations and recommend changes was specifically deleted, and its role limited to advice on matters of "general policy." Also, its purview was extended to include the medicaid program. However, HIBAC has not been called upon to advise the Secretary since late in 1976, and there are currently no members.

Effective Date

The provision would take effect upon enactment.

15. Open enrollment periods for health maintenance organizations and competitive medical plans (sec. 1035 of the bill and sec. 1876 of the Act).

Present Law

Health maintenance organizations (HMO's) are required to have an open enrollment period of at least 30 days during which time they must accept medicare beneficiaries up to the limits of their capacity.

Explanation of Provision

The bill requires the Secretary to designate one 30-day period in which all of the HMO's in an area participating in medicare must have an open enrollment period. The HMO would be permitted, in addition, to conduct open enrollment at other times during the year or hold enrollment open throughout the year. The Secretary would be required to establish annual per capita rates in a manner that assures that the beneficiaries enrolling during the designated 30-day open enrollment period will not have their premiums changed or their benefits decreased for the 12 month enrollment period for which the beneficiary is enrolling.

The Secretary, in establishing the open enrollment period for an area, would be directed to consult with HMO's in a geographic area concerning the timing of the annual 30-day open enrollment period.

The committee understands that there may be some difficulty in administering this provision and has therefore allowed the Secretary to spend a period of not more than three years to phase in this provision. The committee intends that the Secretary make every effort to designate open enrollment periods for different areas as soon as possible and not wait until the second or third year of this period before designating open enrollment periods.

Effective Date

The provision would take effect upon enactment.

16. Deadline for report on including payment for physicians' services to hospital inpatients in DRG payment amounts (sec. 1036 of the bill)

Present Law

The Social Security Amendments of 1983 (P.L. 98-21) required the Secretary of Health and Human Services to report to the Congress recommendations on the advisability and feasibility of making payments for physician services furnished to hospital inpatients based on a diagnosis-related group system and to make legislative recommendations. The report was to be part of the report made to the Congress during 1985.

Explanation of Provision

The bill would specify that the Secretary is to report to the Congress by July 1, 1985. This would establish a date certain for the report and would give the Congress additional time to act on the recommendations contained in the report.

Effective Date

The provision would become effective upon enactment.

17. Flexible sanctions for noncompliance with requirements for end-stage renal disease facilities (sec. 1037 of the bill and sec. 1881 of the Act)

Present Law

Current law and regulations provide for decertification of end-stage renal disease (ESRD) facilities that are not in complete compliance with medicare program requirements.

Explanation of Provision

The bill allows the Secretary to apply intermediate sanctions, such as a graduated reduction of, or denial of a portion of, reimbursement to ESRD facilities, when noncompliance does not jeopardize patient health or safety or justify decertification of such facilities. Noncompliance would, in these cases, mean noncompliance primarily with administrative requirements. The bill would make the sanctions imposed on ESRD facilities comparable to those of nursing homes which are out of compliance.

Effective Date

The provision would take effect upon enactment.

18. Removing costs of nurse anesthetists from DRG-based payments (sec. 1038 of the bill and sec. 1886 of the Act)

Present Law

Under the new prospective payment system enacted as a part of the Social Security Amendments of 1983 (P.L. 98-21), medicare's payments to hospitals under part A will be based on the diagnosis of the patient. Each diagnosis-related group (DRG) payment is intended to cover all the services that hospitals customarily furnish in caring for patients with a specified diagnosis.

Certified registered nurse anesthetists (CRNA's) have a variety of employment arrangements. Nearly 40 percent of all anesthesia services are provided by CRNA's employed by, or under contract with, hospitals. Physicians who provide anesthesia can bill the medicare program directly under part B. These physicians may also employ nurse anesthetists and bill for their services through part B.

P.L. 98-21 provided that all non-physician services provided to hospital inpatients could only be paid for under part A. This would mean that the services of a CRNA employed by physician and currently billed under part B would have to have been billed under part A. Because such a result might disrupt the present employment relationship of CRNA's, the Department of Health and Human Services (HHS) in its regulations of September 1, 1983 established a temporary provision to provide for a transition with respect to the payment for the services of CRNA's billed under part B.

The regulations provide that, if a physician employed nurse anesthetists during a designated period prior to implementation of prospective payment, then that physician may continue to employ CRNAs through cost reporting periods beginning before October 1, 1986.

Explanation of Provision

Despite the effort by the Department of HHS to stabilize the employment circumstances of CRNAs under part B, there remains an incentive for hospitals who currently employ, or contract with, CRNAs to substitute the services of anesthesiologists. The provision in the committee bill is intended to eliminate that incentive. It would apply a similar transition period as that provided with respect to the services of CRNAs under part B.

The bill would remove from the definition of "operating costs of inpatient hospital services," for purposes of the application of the new prospective payment system, costs related to employment of, or contracts for professional services of, certified registered nurse anesthetists. This would mean that hospitals would continue to be reimbursed for the services of such nurse anesthetists on a cost basis. The committee intends, however, that such costs would be subject to such limits as the Secretary may wish to establish.

The committee intends that the provision would be budget neutral for those years in which budget neutrality applies. The committee believes that it would be appropriate for the Department of HHS to reduce the aggregate DRG payment for all hospitals by an amount which represents the costs of CRNAs currently employed by hospitals in order to avoid hospitals receiving duplicate payments for such services.

HHS may also wish to reduce the hospital specific portion (HSP) of a hospital's payment by an amount which reflects the employment of CRNAs. The committee realizes that such adjustments may result in an administrative burden on the Department and, therefore, leaves the appropriate implementation of the adjustments necessary to achieve budget neutrality and avoid duplicate payments to the discretion of HHS.

The Secretary has been required by P.L. 98-21 to report to the Congress on recommendations on the advisability and feasibility of providing for DRG-type payments for physicians' services furnished to hospital inpatients. The bill would require the Secretary to include in that report legislative recommendations on compensation for CRNA's under the DRG system. The committee suggests that the Secretary also look at the advisability of making payments directly to CRNA's.

Effective Date

The provision would be effective with respect to cost reporting periods beginning on or after October 1, 1984, and before October 1, 1986.

19. Determination of hospital area wage index (sec. 1039 of the bill and sec. 1886 of the Act)

Present Law

Under the prospective payment system, the payments made to hospitals are adjusted to reflect differences in area hospital wage levels. The adjustment is an index or ratio based on the average hospital wage level in the geographic area compared to the national average. The index is calculated based on wage and employment data maintained by the Bureau of Labor Statistics (BLS) of the Department of Labor. The data is currently the most reliable national data available. Wage indexes are published for each Metropolitan Statistical Area (MSA)—the successors to SMSA's—and for each rural area as well as for urban and rural areas under classifications established specifically for New England.

Explanation of Provision

If a hospital can demonstrate to the Secretary that the area wage index applied to that hospital does not accurately reflect the actual labor market conditions faced by that hospital, based on criteria established by the Secretary (e.g. that the hospital must draw its employees from an area with a higher wage index), the Secretary shall, where he or she deems appropriate, make an adjustment in the hospital's payments, payable beginning with the next federal fiscal year. The provision would be subject to the limitations of budget neutrality for the years in which budget neutrality is applicable.

The Secretary of Health and Human Services would be directed to consult with the Secretary of Labor and the Commissioner of the Bureau of Labor Statistics to develop methods of refining and improving the adequacy and equity of the area wage index, specifically its applicability to hospital wages. The Secretary of HHS would be required to report to the Congress by June 1, 1984.

The wage index has been used by the Department of HHS for some time in making adjustments to the section 223 cost reimbursement limits in effect prior to prospective payment. Questions have been raised in the past about the equity of the index. Those concerns have become more important with the enactment of prospective payment since the index acutally affects the hospital's payment levels rather than just the cost limits.

The committee expects the Secretary of HHS to consult with the Commissioner of BLS to develop a more sound approach to the area wage index as it applies to all hospitals. For example, the current treatment of part-time employees under the index does not appear to be aprpropriate in its application to hospitals. The Committee believes that many of the problems cited by hospitals with respect to the index could be resolved for all hospitals rather than attempting to resolve problems with the index on a case-by-case basis.

In addition, however, the committee has required the Secretary to establish criteria under which hospitals can appeal the application of the index. Some hospitals argue, for example, that they are just outside an MSA area and must draw labor from the same market as those hospitals within the MSA. The Secretary may also wish to recognize, through such criteria that hospitals within an MSA area may have significant distinctions in their actual labor market experiences from that reflected in the index. In such cases, the Secretary would be authorized to make an adjustment in the hospital's wage index.

An adjustment in a hospital's payment as a result of an adjustment in the hospitals wage index would be made, effective with discharges occurring on or after October 1 following the determination. That is, the adjustment in the index would be effective with the next Federal fiscal year. This is to make the adjustment consistent with the update in the DRG payment at the beginning of each Federal fiscal year and to avoid the necessity of retrospective adjustments under a prospective system.

Finally, the committee wishes to make it clear that any additional expenditure of medicare funds as a result of this provision will be subject to the limitations of budget neutrality for the years in which budget neutrality applies. Thereafter, the Secretary is expected to apply the provision in such a way as to take into account the overriding goal of reducing hospital costs and protecting the soundness of the medicare trust fund.

20. Definition of bona fide emergency services for purposes of limitations on payment for hospital outpatient services (sec. 1040 of the bill and sec. 1861 of the Act)

Present Law

The Budget Reconciliation Act of 1981 (P.L. 97-35) included a provision requiring the Secretary of HHS to place reasonable limits on hospital costs and physician charges for outpatient services. The limits were to be reasonably related to the charges for similar services in physician's offices in the area. The statute specifically exempted from the outpatient limits "bona fide emergency services provided in an emergency room."

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) included a provision to eliminate duplicate overhead payments for outpatient services. The provision added authority for the Secretary to reduce the payment to a physician providing services in an outpatient department by a factor representing the overhead costs already being paid by medicare through the payment to the hospital.

The Secretary of HHS has been left to define by regulation "bona fide emergency services."

Explanation of Provision

The bill would provide for the following statutory definition of "bona fide emergency services":

> Services provided in a hospital emergency room after the onset of a medical condition manifesting itself by symptoms of sufficient severity that the absence of immediate medical attention could reasonably be expected, by a prudent layperson possessing an average knowledge of health and medicine, to result in (a) placing the patient's health in jeopardy; (b) serious impairment to bodily functions; (c) serious dysfunction of any bodily organ or part; or (d) development or continuance of severe pain.

The committee believes that a statutory definition of "bona fide emergency services" is necessary to express clearly the intent of Congress in this regard.

21. Delay of effective date for single-rate for skilled nursing facilities (sec. 1041 of bill)

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) required the Secretary to establish a single payment limit for both free-standing and hospital-based skilled nursing facilities (SNFs), effective October 1, 1982.

In the Social Security Amendments of 1983 (P.L. 98-21), the effective date was postponed for one year. In addition, the Congress required the Secretary to report by December 31, 1983 on the effect of the implementation of the TEFRA single-rate provision on hospital-based SFN's, given the difference (if any) in the patient populations served by such facilities and by freestanding SNF's. Further, the Secretary was required to report by the end of 1983 on the impact of hospital prospective payment on SNF's.

Explanation of Provision

The implementation of the single-rate for SNF's would be postponed until April 1, 1984. The Committee believes it prudent to wait unitl the Secretary has completed her report on hospital-based SNF's before implementing the single-rate provision.

TITLE XI—TRADE ADJUSTMENT ASSISTANCE PROGRAMS

Title XI contains three amendments to the trade adjustment assistance (TAA) programs for workers and firms under the Trade Act of 1974, as amended under the Omnibus Budget Reconciliation Act of 1981. These programs were reauthorized for a two-year period until September 30, 1985, under Public Law 98-120. The amendments would become effective on the date of enactment of the bill.

A. Limitation on Trade Readjustment Allowances (Sec. 1101 of the Bill)

Present Law

Under present law, a worker certified eligible for trade adjustment assistance (TAA) benefits can receive up to 52 weeks of basic trade readjustment allowances (TRA) and unemployment compensation (UI) combined plus up to an additional 26 weeks of TRA if in training. Under section 233(a)(3) of the Trade Act of 1974 as amended in 1981, the additional 26 weeks of benefits can be collected only during the 26-week period immediately following the week the worker exhausts his entitlement to basic TRA benefits (i.e., the 52-week period after exhausting regular UI).

Reasons for Change

Because of delays in certification or delays in approval of training by State employment services, workers are often denied some or all of the extra 26 weeks of TRA by the time they can enter training. As a result, through no fault of their own, these workers may not be able to afford training. The amendment would remove this inequity.

Explanation of Provison

The bill (sec. 1101) amends section 233(a)(3) of the Trade Act to enable workers to receive the additional TRA benefits by beginning the 26-week collection period with the first week the worker is in training if that training has not been approved until after the last week of entitlement to basic TRA benefits. The present law would continue to apply in all cases not involving administrative delays in certifying workers or in approving their training.

B. Job Search and Relocation Allowances

Present Law

Under section 237 of the Trade Act, workers meeting certain eligibility requirements can be reimbursed for 90 percent of their necessary job search expenses up to a maximum of $600. Relocation allowances to eligible workers under section 238 of the Trade Act consist of 90 percent of reasonable and necessary expenses incurred in transporting a worker and his family and household effects, plus a lump sum payment of three times the worker's average weekly wage, up to a maximum of $600. These maximum limits were increased from $500 to $600 under the 1981 amendments to the program.

Reason for Change

The purpose of increasing job search and relocation allowances is to reflect rising costs and to encourage greater worker mobility to reemployment opportunities which may exist beyond their present commuting distance.

Explanation of Provision

The bill (sec. 1102) amends section 237(a)(1) of the Trade Act to increase the maximum job search allowance from $600 to $800. The bill also amends section 238(d)(2) of that Act by increasing the maximum lump sum payment for relocation from $600 to $800.

C. Assistance to Industry (Sec. 1103 of the Bill)

Present Law

Section 265 of the Trade Act, added as part of the 1981 program amendments, authorizes the Secretary of Commerce to provide technical assistance on an industry-wide basis through existing agencies, private individuals, firms, universities, and institutions, and by grants, contracts, or agreements to trade associations, labor unions, or other nonprofit industry organizations whose membership includes a substantial number of firms who have been certified eligible to apply for TAA.

The focus of this program is different from the technical assistance available on a firm-by-firm basis. While technical assistance for an individual firm is furnished primarily to assist that firm in petitioning for TAA and/or in developing and carrying out its own economic adjustment plan, industry-wide technical assistance is designed to support new product development, new process development, export development, and other activities that enhance the future competitive position of entire industries in transition. Current law limits this kind of technical assistance, however, to $2,000,000 annually per industry.

Reasons for Change

Many workers within an industry may be certified as import impacted yet firms in the same industry chose not to petition for TAA or are not certified. The first amendment to section 265 would allow an industry to receive technical assistance if a substantial number of firms or workers have been certified.

Both changes are intended to make available technical assistance funds to basic industries where it can serve as "seed" money for research and development essential to the restructuring and revitalization of those basic industries.

Technical assistance for industry-wide programs for new product development, process development, export development, or other uses consistent with supporting an industry's adjustment to import competition should include those projects associated with next generation research and development. Such projects designed to improve significantly an industry's overall competitiveness and to ensure its future long-term viability should be given priority over programs that provide only marginal improvements in an industry's immediate competitive position.

Explanation of Provision

The bill (sec. 1103) amends section 265 of the Trade Act in two respects. Paragraph (1) amends section 265(a) to extend eligibility for industry-wide technical assistance to industries in which a substantial number of workers have been certified for trade ajdustment assistance. Currrently, an industry is eligible for technical assistance only if a substantial number of firms within that industry have been certified.

Paragraph (2) of section 1103 amends section 265(b) to increase from $2,000,000 to $10,000,000 the amount of assistance that can be provided annually to a single industry.

TITLE XII—HIGHWAY VEHICLE USE AND DIESEL FUEL TAXES

(Secs. 1201-1203 of the bill and secs. 4041(a), 4481, 6427 and 9503 of the Code)

Present Law

Heavy vehicle use tax

In general

An annual excise tax is imposed on the use on the public highways of any highway motor vehicle whose taxable gross weight exceeds a prescribed minimum weight. The term "taxable gross weight" means the sum of (1) the unloaded weight of the vehicle when fully equipped for service; (2) the unloaded weight of semitrailers and trailers, when fully equipped for service, which are customarily used in connection with vehicles of the same type; and (3) the weight of the maximum load customarily carried on vehicles, semitrailers, and trailers of the same type.

Exemptions are provided for uses by State and local governments and the United States. In addition, the use of private transit buses for which certain fare requirements are met is exempt.

The taxable period for the highway use tax is generally the one-year period beginning on July 1. The amount of tax is prorated when the first use of the vehicle during the taxable period occurs later than the first month of the period. Payment in quarterly installments is permitted. The tax is paid by the person in whose name the vehicle is registered. Beginning in fiscal year 1985, up to 25 percent of Federal Interstate highway funds could be withheld from a State which fails to require proof of use tax filing before registering vehicles.

Rate of tax

For uses occurring before July 1, 1984, the annual rate of tax is $3 per 1,000 pounds of taxable gross weight or fraction thereof. However, the use of vehicles whose taxable gross weight is 26,000 pounds or less is exempt.

For uses occurring after June 30, 1984, the rate of tax is graduated according to taxable gross weight:

SCHEDULE OF HIGHWAY USE TAX, JULY 1, 1984 AND AFTER

Taxable gross weight		Rate of tax
At least:	But less than:	
33,000 pounds	55,000 pounds	$50 per year, plus $25 for each 1,000 pounds or fraction thereof in excess of 33,000 pounds.
55,000 pounds	80,000 pounds	$600 per year, plus the applicable rate for each 1,000 pounds or fraction thereof in excess of 55,000 pounds.
80,000 pounds or more.		The maximum amount.

The applicable rate and maximum amount are as follows:

Taxable period beginning on July 1, of	Applicable rate	Maximum amount
1984	$40	$1,600
1985	$40	$1,600
1986	$44	$1,700
1987	$48	$1,800
1988 or thereafter	$52	$1,900

This schedule applies with a one-year delay in the case of a person (a small owner-operator) who owns and operates no more than 5 taxable vehicles during a taxable period. The tax expires on October 1, 1988, and the amount of tax for the taxable period beginning on July 1, 1988, is prorated accordingly, as one-fourth of the annual tax.

Two additional rules are generally effective as of July 1, 1984. First, a vehicle that travels fewer than 5,000 miles on the public highways during a taxable period is exempt from the use tax, regardless of its taxable gross weight. Second, a credit or refund is allowed on a pro rata basis, if a vehicle on which the use tax has been paid is retired from service because of theft, accident or other casualty. Under present law, these additional rules are effective as of July 1, 1985, for small owner-operators.

Amounts equivalent to the taxes received in the Treasury from the heavy vehicle use tax are appropriated to the Highway Trust Fund.

Diesel fuel tax for highway vehicles

Present law imposes a 9-cents-per-gallon excise tax on the sale of diesel fuel for use in a highway vehicle. The tax terminates on October 1, 1988.

A number of exemptions are provided from the entire 9-cents-per-gallon tax. Other uses of diesel fuel are exempt from only a portion of the tax. The following table summarizes the exemptions and amount of each exemption.

EXEMPTIONS FROM TAX ON DIESEL FUEL

Exemption	Amount of exemption
Alcohol fuels mixture	5 cents/gal.
Intercity, school, and local buses	4 cents/gal.
Qualified taxicabs (through Sept. 30, 1984)	4 cents/gal.
State and local governments	9 cents/gal.
Nonprofit educational institutions	9 cents/gal.
Farming use	9 cents/gal.
Off-highway business use	9 cents/gal.
Certain aircraft museums	9 cents/gal.
Export	9 cents/gal.

Amounts equivalent to the taxes received in the Treasury from the diesel fuel tax are appropriated to the Highway Trust Fund. One-ninth of these amounts (currently, 1 cent per gallon of the 9-cents-per-gallon tax) is designated for the Mass Transit Account in the Highway Trust Fund.

Reasons for Change

The committee believes that highway excise taxes should be restructured to reduce the scope and magnitude of the heavy vehicle use tax. Taxpayers have objected that the higher rates scheduled to take effect this year will impose a large tax that is not necessarily related to the amount of business they may do, and that an alternative form of highway excise taxation should be devised which is more definitely correlated with use. The committee agrees with this position.

However, the committee does not believe that the heavy vehicle use tax should be eliminated. One objective of highway excise taxation is to impose taxes on highway users that are proportionate to the public highway costs which are allocable to their respective uses. These costs generally depend not only on mileage but also on vehicle weight. Thus, the committee decided to retain so much of a heavy vehicle use tax as is necessary (when taken in combination with modifications to the diesel fuel tax) to approximately maintain the present law relation between highway taxes and allocable costs for various types of highway vehicles.

Finally, the committee decided that modifications to the highway excise taxes should not result in any significant change in Highway Trust Fund receipts over the scheduled duration of these taxes.

Explanation of Provisions

1. Highway vehicle use tax

The bill modifies the heavy vehicle use tax in three respects, for uses occurring after June 30, 1984.

First, the bill raises the threshold level at which vehicles become subject to the tax from 33,000 to 55,000 pounds of taxable gross weight.

Second, the bill restructures the rate of tax. In general, the rate of tax on vehicles whose taxable gross weight is at least 55,000 pounds but is not more than 72,000 pounds is modified to $150 per year, plus $20 per 1,000 pounds of taxable gross weight (or fraction thereof) in excess of 55,000 pounds. The bill provides that the maximum rate of tax, applicable to vehicles with taxable gross weight over 72,000 pounds, is $500 per year. A special rule is provided for small owner-operators for the taxable period beginning July 1, 1984, according to which the rate of tax is $3 per 1,000 pounds of taxable gross weight for vehicles whose taxable gross weight is 55,000 pounds or more. However, if this special rule would produce a greater use tax on a small owner-operator's vehicle than does the general rate of use tax, then the general rate of tax applies to that vehicle for the taxable period beginning July 1, 1984. The general rate of tax provided by the bill, which applies to persons other than small owner-operators beginning July 1, 1984, applies to small owner-operators beginning July 1, 1985.

Third, the bill makes the 5,000-mile exemption and proration for theft or casualty available to small owner-operators beginning July 1, 1984, the same day on which these rules apply to persons other than small owner-operators under present law.

In addition, the bill requires the Secretary of Transportation (in consultation with the Secretary of the Treasury) to study whether trucks weighing 80,000 pounds or more bear their fair share of the costs of maintaining the highway system, and to submit a report thereon within 1 year after the date of enactment to the tax-writing committees of Congress.

2. Diesel fuel tax for highway vehicles

The bill increases the excise tax on diesel fuel to 14-1/2 cents per gallon. The bill makes no amendments to the exemptions provided under present law. Therefore, exemptions from the entire amount of tax (i.e., 9 cents per gallon currently) will rise to the new level (i.e., 14-1/2 cents per gallon). The exemptions provided for alcohol fuels mixtures, and certain buses and taxicabs will continue at 5 cents and 4 cents per gallon, respectively. The committee intends that any retail dealer who, on the effective date of the increased diesel fuel tax, holds diesel fuel upon which tax has been paid at a rate of 9 cents per gallon shall pay an amount equal to 5.5 cents per gallon on such fuel.

To maintain the currently effective designation of amounts to the Mass Transit Account, the bill provides that 1 cent per gallon of the 14.5-cents-per-gallon tax is designated to that account.

3. Advanced repayment of additional tax

In general

To offset the increase in fuel cost for diesel-powered vehicles having a gross vehicle weight of 10,000 pounds or less, the bill provides an advance repayment of the additional 5.5-cents-per-gallon diesel fuel tax expected to be paid over the normal useful life of the vehicle to certain purchasers and certain current owners of such vehicles. The repayment is available only to the person who is the original purchaser of a diesel-powered vehicle purchased after January 1, 1985, and before January 1, 1988, and to the holder as of January 1, 1985, of a vehicle purchased before that date.

The amount of the repayment depends upon the model year of the vehicle, and on the vehicle type, e.g., truck or car. The applicable repayment amounts are as follows:

Model year	Amount of credit	
	Cars	Trucks
Before 1979	0	0
1979	$16	$30
1980	32	60
1981	48	90
1982	64	120
1983	80	150
1984–1988	96	180

These repayments will be payable out of the Highway Trust Fund.

Definition of original purchaser

Generally, the original purchaser of a vehicle will be the first person who purchases a vehicle for use other than resale. In the case of a vehicle acquired for lease to another party, the purchaser and not any lessee is eligible for the credit, regardless of the term of the usual lease in the purchaser's business. Original purchasers do not include any State or local government or nonprofit educational organization, because diesel fuel used by these entities is not subject to the diesel fuel tax.

Special rules

The advance repayment must be claimed on the purchaser's income tax return for the taxable year in which a qualified vehicle is purchased. A person who holds a qualified vehicle on January 1, 1985, will be treated as if he or she purchased the vehicle on December 31, 1984. In the case of a person exempt from income tax, but subject to the diesel fuel tax on fuel used in vehicles it operates, the credit will be effected by a direct claim filed with the Internal Revenue Service, pursuant to rules established for such claims by the IRS.

In the case of a qualified vehicle used for a business or income-producing purpose, the basis of the vehicle (and the limitation on the basis of luxury automobiles, as provided in sec. 166 of the bill), will be reduced by the amount of advance repayment provided by the bill for that vehicle.

Effective Dates

The amendments to the heavy vehicle use tax and the diesel fuel tax are effective on July 1, 1984. The bill retains the present October 1, 1988, scheduled termination of those taxes.

Revenue Effect

[In millions of dollars]

	Fiscal year					
	1984	1985	1986	1987	1988	1989
Highway use tax	−240	−548	−616	−675	−581	....
Diesel fuel tax	86	502	635	645	695	45
Net effect	−154	−46	19	−30	114	45

VI. BUDGET EFFECTS AND VOTE OF THE COMMITTEE

A. Committee Estimates

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made relative to the effect on the budget by the committee amendment to H.R. 4170, as reported by the committee. The committee agrees with the cost estimate regarding the spending (outlay) provisions (included in item B., below) prepared by the Congressional Budget Office based upon their most recent economic projections.

The table below summarizes the budget effects of the tax and other provisions in the bill for fiscal years 1984–1989. Separate revenue or budget estimates are shown in the text (Part V) for each title of the bill. Detailed estimates for the tax provisions are shown in Part IV (Revenue Effects) of this committee explanation.

SUMMARY BUDGET EFFECTS OF H.R. 4170

[In millions of dollars]

Item	Fiscal year					
	1984	1985	1986	1987	1988	1989
Revenue effects of tax provisions (titles I–VIII and XII)	2,001	9,175	16,733	21,266	21,487	21,661
Budget outlays:						
Payments of excise tax revenues to Puerto Rico and the U.S. Virgin Islands (title I)	0	−149	−240	−260	−264	−264
Social security disability provisions (title IX)	57	328	375	369	369	277
Medicare provisions (title X)[1]	−56	−448	−573	−717	−849	−997
Trade adjustment assistance provisions (title XI)	([2])	([2])	([2])	([2])	([2])	....
Total budget outlays effects	0	−269	−438	−608	−744	−984

[1] The savings stated for this title assume House approval of a separate committee amendment related to a freeze on payment for physician services provided to hospital inpatients and with a requirement for mandatory assignment of claims for those services.

[2] Less than $500,000.

The Office of the Actuary, Social Security Administration, has also estimated the impact of the disability amendments to Title II of the Social Security Act over a 75-year period. Under II–B economic assumptions, the disability trust fund remains in actuarial balance.(The estimates of the Office of the Actuary can be found below, Item C.)

B. Cost Estimate Prepared by the Congressional Budget Office

In compliance with 2(l)(3)(C) of rule XI, requiring a cost estimate prepared by the Congressional Budget Office, the following report prepared by Congressional Budget Office is provided concerning budget outlay effects of the spending provisions of the bill. A letter concerning revenue effects of the tax provisions is for the coming.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., March 5, 1984.

Chairman, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Pursuant to Section 403 of the Congressional Budget Act of 1974, the Congressional Budget Office has prepared the attached cost estimate for Titles I (section 135), IX, X, and XI of H.R. 4170, The Tax Reform Act of 1984, as amended and ordered reported by the House Ways and Means Committee on March 1, 1984. Titles IX, X, XI, and Title I (section 135) contain the spending provisions in H.R. 4170. An estimate of the revenue provisions in Titles I through VIII is being provided under separate cover.

Should the Committee so desire, we would be pleased to provide further details on this estimate.

Sincerely,

RUDOLPH G. PENNER,
Director.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

MARCH 5, 1984.

1. Billing number: H.R. 4170.
2. Bill title: The Tax Reform Act of 1983.
3. Bill status: As amended and ordered reported by the House Committee on Ways and Means, March 1, 1984.
4. Bill purpose: To provide for tax reform, and for other purposes.
5. Estimated cost to the Federal Government: This estimate is only for the spending provisions in H.R. 4170 in Titles IX, X, XI, and section 135 of Title I. An estimate of the revenue provisions. in Titles I through VIII is being provided under separate cover. The section below shows only the sections that have a budgetary impact.

[By fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988	1989
Title I—Section 135:						
Budget authority	0	−149	−240	−260	−264	−264
Outlays	0	−149	−240	−260	−264	−264
Title IX						
Budget authority	10	30	14	−17	−35	−73
Outlays	57	328	375	369	369	277
Title X						
Budget authority	−170	−487	−614	−758	−897	−1,052
Outlays	−57	−448	−573	−717	−849	−997
Title XI						
Budget authority/authorization	(1)	(1)	0	0	0	0
Outlays	(1)	(1)	0	0	0	0
Total:						
Budget authority/authorization	−160	−606	−840	−1,035	−1,196	−1,389
Outlays	0	−269	−438	−608	−744	−984

[1] less than $500,000.

Basis of Estimate: A May 1, 1984 enactment date has been assumed for sections where an effective date has not been included in H.R. 4170. Title I (section 135) would alter payments of excise tax revenues to Puerto Rico and the U.S. Virgin Islands.

The Title IX proposals that affect the Disability Insurance programs are shown below. Included on this table are the impacts of the Disability Insurance proposals on the Medicare, Medicaid, and Supplemental Security Income programs.

TITLE IX

[Outlays, by fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988	1989
Termination of benefits based on medical improvement:						
DI	22	86	123	130	136	133
HI and SMI	4	25	35	40	40	40
Medicaid	(1)	3	4	4	4	4
SSI	1	3	4	4	4	4
Multiple impairments:						
DI	(1)	4	7	11	13	15
HI and SMI	(1)	(1)	(1)	1	2	2
Medicaid	(1)	(1)	1	1	1	1
SSI	(1)	1	2	2	3	3
Face-to-face evidentiary hearings for reviews: DI	0	11	11	8	6	5
Continued payment during appeal:						
DI	25	149	134	114	107	31
HI and SMI	3	48	50	40	30	10
Medical personnel qualifications:						
DI	(1)	7	14	23	25	27
HI and SMI	(1)	(1)	1	2	5	7
Medicaid	(1)	(1)	1	2	3	4
SSI	(1)	2	3	5	6	7
Compliance with court orders:	(2)	(2)	(2)	(2)	(2)	(2)
Vocational rehabilitation:						
DI	(1)	2	4	7	8	8
HI and SMI	(1)	(1)	(1)	(1)	(1)	(1)
SSI	(1)	(1)	(1)	(1)	(1)	(1)
Extension of sections 1619a and 1619b:						
Medicaid	3	7	5	0	0	0
SSI	(1)	1	1	0	0	0

TITLE IX—Continued

[Outlays, by fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988	1989
Total costs or savings:						
Budget authority	10	30	14	−17	−35	−73
Estimated outlays([3])	57	328	375	369	369	277

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[1] Less than $500,000.

[2] The costs of this provision cannot be estimated because they depend on future court decisions.

[3] The details do not add to the totals due to interaction between provisions.

The following table shows the Title X proposals that affect the Medicare program. The table also includes the impact of the Medicare proposals on the Medicaid program.

TITLE X

[Outlays, by fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988	1989
Medicare (Function 570):						
Clinical labs	−40	−250	−315	−390	−450	−530
Hepatitis B vaccine	3	−1	−2	−2	−4	−4
Limitation on certain foot care	−4	−11	−11	−12	−13	−14
Physician fee freeze	−15	−250	−300	−360	−420	−480
Hospital area wage index			([1])	([1])	([1])	([1])
Delay single rate for SNFS	10	20				
Impact of medicare changes on premiums		89	109	111	113	116
Medicaid (Function 550):						
Impact of medicare changes on medicaid	−11	−45	−54	−64	−75	−85
Total:						
Budget authority	−170	−487	−614	−758	−897	−1,052
Outlays	−57	−448	−573	−717	−849	−997

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[1] This proposal may have a budget impact in 1986 and in future years as the budget neutrality provision will no longer be in effect.

The Title XI proposals that affect Trade Adjustment Assistance are shown below.

TITLE XI

[Outlays, by fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988
Trade adjustment assistance (Functions 370, 500, and 600):					
Limitations on trade adjustment allowances (sec. 1101)	([1])	([1])			
Job search and relocation allowances (sec. 1102)	([1])	([1])			
Assistance to industry (sec. 1103)					
Total:					
Required budget authority/authorization level	([1])	([1])			
Estimated outlays	([1])	([1])			

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[1] Less than $500,000.

6. Estimated cost to State and local governments: The provisions in Title IX of this bill that affect SSI would increase expenditures of state and local governments. Their estimated net impact on state and local expenditures is less than $15 million a year.

The changes in SSI would increase state and local government costs because virtually all states supplement federal SSI benefits.

By making more persons eligible for SSI benefits, state costs would increase. States are also affected by the added outlays in Medicaid because states finance a portion of the program. The current state financing share is 46 percent.

There could be come offsets to these added SSI and Medicaid costs to the extent that persons made eligible for SSI by the bill might otherwise be eligible for general assistance or health care financed fully by states and localities. These potential offsets are not included in the cost estimate.

Several of the changes in Title X to Medicare would affect Medicaid spending since about 15 percent of those covered by Medicare are also covered by Medicaid. Changes in estimated state and local Medicaid spending are shown below.

[By fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988	1989
Estimated changes in State and local spending in medicaid	−10	−30	−35	−45	−55	−65

The clinical lab and physician fee freeze proposals would reduce Medicare expenditures to providers and save money in both the Medicare and Medicaid programs. The increase in Part B premiums would result in an increase in Medicaid expenditures to those states that buy into the Medicare program.

7. Estimate comparison: None.

8. Previous CBO estimate: On October 31, 1983, CBO provided an estimate of H.R. 4170, as ordered reported by the House Ways and Means Committee on October 19, 1983. This estimate is updated for recent Committee action and for later effective dates.

9. Estimate prepared by: Diane Burnside, Hinda Ripps Chaikind, Stephen Chaikind, Richard Hendrix, Kelly Lukins, Janice Peskin, and Jack Rodgers.

10. Estimate approved by: C. G. Nuckols for James L. Blum, Assistant Director for Budget Analysis.

C. Administration Estimate of Financial Impact of Title IX

The following tables, prepared by the Office of the Actuary, Social Security Administration, and the Department of Health and Human Services summarize the estimated long-range and short-range financial impact of Title IX of the bill.

Estimated Cost of the Social Security Disability Provisions, Fiscal Years 1984–88

[In millions]

Provision	Fiscal year—					Total 1984–88
	1984	1985	1986	1987	1988	
OASDI benefit payments	$60	$390	$580	$650	$730	$2,410
OASDI administrative expenses	25	105	130	126	131	517
Medicare	25	45	65	80	95	310
Medicaid	13	21	21	15	20	90
SSI	3	2	9	19	23	50
Total	120	563	805	890	999	3,377

NOTE.—These estimates were made by the Office of the Actuary, Social Security Administration, based on the alternative II-B assumptions of the 1983 Trustees' Reports as revised in November 1983.

Source: Social Security Administration, Office of the Actuary, January 1984.

Estimated Long-Range Financial Impact of the Social Security Disability Provisions

Bill section	Provision	Change in long-range OASDI actuarial balance (as percent of taxable payroll)
901.	Standard of review for terminations of disability benefits	(1)
902.	Study concerning evaluation of pain	(1)
903.	Guidelines for disability determinations:	
	Multiple impairments	(1)
	Noncompetitive work	(1)
	Work evaluation in mental impairment cases [2]	(1)
904.	Moratorium and revised criteria for mental impairment cases	(3)
905.	Review procedure governing disability determinations affecting continued entitlement to disability benefits; demonstration projects relating to review of denials of disability benefit applications	(1)
906.	Continuation of benefits through ALJ decisions	−0.01
907.	Qualifications of medical professional evaluating mental impairments	(1)
908.	Regulatory standards for consultative examinations	(1)
909.	Administrative procedure and uniform standards	(1)
910.	Compliance with certain court orders	(1)
911.	Revision of vocational rehabilitation criteria	(1)
912.	Advisory Council on Medical Aspects of Disability	(1)
913.	Qualifying experience for appointment of certain staff attorneys to ALJ positions	(1)
	Total [4]	−0.02

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[1] Change in long-range OASDI actuarial balance is less than 0.005 percent of taxable payroll.

[2] Report language urges full "work evaluation" by a vocational expert in "borderline" mental impairment cases.

[3] The financial effect of this provision is attributed to the Secretary's initiative of June 7, 1983 for revising the criteria for evaluating mental impairment cases. Illustrative estimates of the change in the long-range OASDI actuarial balance for this revision are −0.03, −0.07, and −0.15 percent of taxable payroll based on the assumption that 10 percent, 25 percent of 50 percent of current mental impairment denials would be allowed (slightly higher percentages are assumed for current CDI

terminations). At this time it is not known what provisions would be made to these criteria.

[4] Total includes the effect of interaction among sections.

NOTE.—The estimates in this table are based on the alternative II-B assumptions of the 1983 Trustees Report.

Source: Social Security Administration, Office of the Actuary, Sept. 19, 1983.

D. Vote of the Committee

In compliance with clause 2(l)(2)(B) of Rule XI of the House of Representatives, the following statement is made about the vote of the committee on the motion to report the committee amendment to H.R. 4170. The committee amendment, to be offered as a substitute for the previously reported H.R. 4170, was ordered favorably reported by voice vote.

VII. OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

In compliance with clause 3(l)(3) and 2(l)(4) of Rule XI of the Rules of the House of Representatives, the following statements are made with respect to the committee action on the committee amendment to H.R. 4170, as reported.

Oversight Findings

With respect to subdivision (A) of clause 2(l)(3) (relating to oversight findings), the committee advises that it was as a result of the committee's oversight responsibilities with respect to the Internal Revenue Code that caused it to conduct public hearings and assess the need for legislation in several areas of the tax law. In addition, continuing concern with cost control in the medicare program and administrative difficulties in defining and determining medical disability require constant revaluations of programs, their constituent elements and their administration. The committee also determined that there is a need to amend the trade adjustment assistance provisions.

Details on the committee and subcommittee hearing and markup consideration of the various titles of the bill are contained in Part I (Legislative Background) of this report. Following is a brief summary of the purposes of each of the 12 titles in the committee bill.

Nine titles of the bill relate to the Internal Revenue Code. Title I generally freezes in the form they are in present law a number of tax provisions that would produce revenue reductions during the next 5 years. Because of the projected budgetary deficit situation in the current and next several fiscal years, the committee decided that the several selective revenue reductions should be deferred until the Federal Government's fiscal policy can be less restrictive. This title also incorporates many general tax reforms that will restrict or eliminate many abusive tax practices. Title I also deals with leasing, sale-leaseback, and analogous financial arrangements between the private business sector and tax-exempt public and private organizations with respect to real and personal property. The activities that have attracted attention involved little or no economic substance and were motivated primarily by profitable financial manipulations to make available to tax-exempt entities some of the tax benefits ordinarily available to private profit-seeking organizations. The committee was lead by the evidence presented in public hearings to the conclusion that legislation was necessary to preclude further nonsubstantive extensions of tax incentives beyond the intended beneficiaries.

Title II (Life Insurance Tax Provisions) responds to the mandate in TEFRA to provide permanent solutions to problems in the tax treatment of the life insurance industry that were given temporary adjustments last year. Title III (Revision of Private Foundation Provisions) makes further adjustments in the law regulating charitable contributions and private foundations, and the relationships between private foundation and contributors. In addition, the excise tax on private foundation investment income is reduced in certain circumstances. These are changes made as part of the continuing committee oversight in this area, including hearings and report by the Subcommittee on Oversight.

In Title IV (Tax Simplification Provisions), the income tax rules in many areas were modified in ways to simplify taxpayer compliance and administration without at the same time making substantive changes in the underlying policy in these areas. This included revisions of estimated tax payment provisions, domestic relations provisions, a reordering and rationalization of the various income tax credits, and other improvements in the tax law.

For the past 5 years, there has been a moratorium on the issuance by the Treasury Department of regulations that relate to the income tax treatment of nonstatutory fringe benefits. In Title V of the bill (Fringe Benefits Provisions), the committee has provided specific statutory authority with regard to many of these benefits, and in the Code provisions rules are established to determine the degree of exclusion from gross income.

Title VI (Technical Corrections Provisions) contains necessary technical, clerical, conforming and clarifying amendments to provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982, the Subchapter S Revision Act of 1982, the Highway Revenue Act of 1982, the Social Security Amendments of 1983, and other recently enacted tax legislation.

Title VII (Tax-Exempt Bond Provisions) involves matters of urgent concern to Federal, State and local governments and many parts of the nongovernment community. The authority to issue qualified mortgage subsidy bonds expired at the end of 1983, and the committee had to act on the subject unless it intended to permit the authority to expire permanently. In addition, the continuing expansion in the flow of private purpose tax-exempt revenue bonds has affected the structure and volume of activity in the tax-exempt bond market and has raised again the question about where to place limits on the issuance of private purpose tax-exempt revenue bonds.

Miscellaneous adjustments to tax provisions that did not fit into the other titles are in Title VIII of the bill.

In Title XII, the committee bill revises the Highway Revenue Act of 1982 by changing the manner in which heavy trucks and trailers are taxed. The heavy vehicle use tax is restructured to reduce the tax while at the same time increasing the tax on diesel fuel used by trucks to make the highway excise tax burden on trucks more commensurate with their actual miles on the highways. The change in taxes is revenue neutral in that the projected revenues into the Highway Trust Fund will neither increase nor decrease over the revenues projected in the Highway Revenue Act of 1982.

Eligibility for disability benefits under the social security program is dealt with in Title IX (Social Security Disability Benefits Reform Act). Since there has been considerable controversy recently about the standards for determination of eligibility for disability benefits, the committee undertook a substantive overhaul of the provisions.

Title X contains amendments to the laws regarding certain health care costs under the medicare program. Finally, title XI contains three amendments to the Trade Adjustment Assistance Programs, which recently was reauthorized, that will improve the efficiency of the program in realizing the intended objectives.

New Budget Authority and Outlays

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill affect new budget authority and outlays as described above in part VI of this report.

Tax Expenditures

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing tax law by this bill involve the following changes in tax expenditures.

The overall thrust of the tax provisions is to reduce the amount of revenue that is not collected because of tax expenditure provisions. Tables in the part of this report on overall revenue effects (Part IV., above) present detailed estimates of revenue effects of the changes in tax expenditures and other tax provisions. The life insurance tax provisions (Title II) involve a net loss in revenue in each year of the 6-year period. The provision for nondeductible IRAs (in Title II) is a new tax expenditure through the tax deferral on the interest earnings of the deposits. The life insurance provisions restructure the tax provisions affecting the industry, and from the perspective of tax expenditures, the bill exchanges a larger number of tax expenditures for a smaller number.

The titles relating to private foundations, simplification provisions and technical corrections tend to be administrative in character and negligible as far as net revenue impact, even if a tax expenditure is added or expanded. The fringe benefit provisions (Title V) formally increase tax expenditures because they codify administrative practices which have excluded these income-in-kind payments from gross income. However, the bill generally reduces tax expenditures because it leaves unchanged or reduces the scope of fringe benefits in present statutory and administrative tax provisions.

Changes in the law relating to tax-exempt bonds (Title VII) will bring about a reduction in the revenue loss from some industrial revenue bonds as the volume limitations will reduce the growth in issuance of IDBs. The 5-year extension and revision of the mortgage subsidy bond provisions will involve increased tax expenditures of $4.0 billion over the 6-year (1984–1989), but the revisions of the other IDB provisions will reduce the revenue loss from the other tax expenditures. The net effect of the title VII tax-exempt bond changes will be to increase overall tax expenditures by $1.4 billion over the 6-year period.

The provisions in title VIII (miscellaneous tax provisions) will involve some increases and decreases in tax expenditures; the amounts are shown in Part IV of the report.

Consultation with Congressional Budget Officials on Budget Estimates

With respect to subdivision (C) of clause 2(l)(3), the committee advises that the Director of the Congressional Budget Office has examined the committee's revenue estimates (as indicated in Part IV of this report) and submitted the following statement:
(TO BE SUPPLIED)

Oversight by Committee on Government Operations

With respect to subdivision (D) of 2(l)(3), the committee advises that no oversight findings or recommendations have been submitted to the committee by the Committee on Government Operations regarding the subject matter of this bill.

Inflationary Impact

In compliance with clause 2(l)(4), the committee states that the enactment of this bill is expected to contribute to a modest decrease in inflationary pressures in the future by raising revenues (an estimated $49.2 billion over the 4-year period, fiscal years 1984–1987), which reduce the projected budget deficit and the consequent need of the Federal Government to borrow money in competition with the private sector. Further inflationary restraints will develop from the restriction on private purpose tax-exempt bonds because the businesses affected by the amendments will be required to compete for funds at the higher rates in the taxable money market. The restraints on public property leasing and tax-shelter and other tax reforms in Title I will redirect the use of otherwise investable funds to substantive economic projects that provide prospective profit-making opportunities that will increase both production and productivity. The tax freeze provisions in Title I will reduce potential budget deficits by avoiding tax reductions in the next several fiscal years.

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